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Uncertainty > Risk: Lessons for Legal Thought from the Insurance Runoff Market

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TOM BAKER

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UNCERTAINTY > RISK: LESSONS FOR LEGAL THOUGHT FROM THE INSURANCE RUNOFF MARKET

TOM BAKER*

Abstract: Insurance ideas inform legal thought: from tort law, to health law, to theories of distributive justice. Within legal thought, insurance is often conceived as an ideal type in which insurers distribute determinable risks through contracts that fix the parties' obligations in advance. This ideal type has normative appeal because, among other reasons, it explains how tort law might achieve in practice the objectives of tort theory, such as deterrence and loss-spreading. Significantly for tort theory, this ideal type supports a restrictive vision of liability-based regulation because uncertainty poses an existential threat to insurance markets that are understood to require insurance to meet this ideal type. Prior work has criticized this restrictive vision on normative grounds. This Article criticizes that vision on empirical grounds. The Article describes an emerging secondary insurance market—the insurance runoff market—that transfers liabilities under insurance policies issued many years in the past. Having started with old asbestos and hazardous waste liabilities, the market now extends to other liabilities that have not worked out well for the companies that insured them, including workers compensation, savings-linked life insurance, pension and annuity guarantees, and long-term-care insurance. Runoff specialists reprice these legacy insurance liabilities with hindsight, consolidate them, and take calculated risks that encourage capital to enter the runoff market. That market transforms the uncertainties of yesterday into today's tradable risks, bringing into the open a dynamic that pervades insurance markets: namely, the promises that are made in all insurance policies get bundled and reconceptualized into sets of liabilities that are valued and revalued, further combined, and redefined over time. Through the lens of the runoff market, we can see many ways that insurance organizations manage uncertainty, revealing the resilience in insurance markets and the flexibility and innovation that produce that resilience. The runoff market counsels us to give much less weight to arguments that expanding liability will undermine insurance markets. Insurance already involves so much uncertainty, and insurers have so many ways to manage it, that the most likely result will always be that they will continue to muddle through.

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* William Maul Measey Professor, Penn Law School. Thank you to the runoff market participants who have generously spoken to me, not all of whom agree with my analysis or conclusions. For helpful comments on earlier drafts, thank you to Kenneth Abraham, Sean Fitzpatrick, Kyle Logue, Peter Molk, Victor Nelligan, Travis Pantin, Natasha Sarin, Tony Sebok, Peter Siegelman, Shauhin Talesh, and Ben Zipursky. Thank you to Alexis Caris, George Eichelberger, Taylor Hertzler, Kayla Katz, and Sam Tang for research assistance. Thank you for feedback from participants at workshops at Villanova, Hebrew University, IDC, and Penn Law Schools.

INTRODUCTION

Insurance ideas, practices, and metaphors inform legal thought. From the loss spreading that powered the expansion of tort liability, to the moral hazard that haunts financial services regulation, to the adverse selection that lies behind the design of the Affordable Care Act, and even to theories of distributive justice, an insurance idea or metaphor often lies at the core of the legal analysis.¹ Scholars in diverse fields, such as civil procedure, torts, corporations, contracts, and employment law, use insurance practices as a window through which to see the law in action.² Legal historians study private insurance to learn about the origins of the welfare state.³ And recent legal scholarship re-

¹ On loss spreading and torts, see, for example, Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499, 543–44 (1961) (arguing that one justification of enterprise liability is that the employer is best situated to obtain insurance); George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1525 (1987) (“This insurance rationale suffuses our modern civil law . . .”). On moral hazard and financial services regulation, see, for example, Kathryn Judge, *The First Year: The Role of a Modern Lender of Last Resort*, 116 COLUM. L. REV. 843, 905 (2016) (discussing the relation between insurance policies and credit default swaps); see also Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 244–67 (1996) (explaining the origins of the term “moral hazard” in the insurance trade). On legal rules designed to address adverse selection, see Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 YALE L.J. 1223, 1235–40 (2004) (explaining how adverse selection could affect behavior in the insurance market); compare Tom Baker, *Containing the Promise of Insurance: Adverse Selection and Risk Classification*, in RISK AND MORALITY 258, 261–64 (Richard V. Ericson & Aaron Doyle eds., 2003) (explaining origins of the term “adverse selection” in the insurance trade). On insurance metaphors in distributive justice, see, for example, RONALD DWORKIN, SOVEREIGN VIRTUE: THE THEORY AND PRACTICE OF EQUALITY 73–83 (2000) (developing a distributional theory using a hypothetical insurance market); Daniel Markovits, *How Much Redistribution Should There Be?*, 112 YALE L.J. 2291, 2304–05 (2003) (using Dworkin’s model to reveal limits to redistribution).

² See, e.g., Bernard Black et al., *Stability, Not Crisis: Medical Malpractice Claim Outcomes in Texas, 1988–2002*, 2 J. EMPIRICAL LEGAL STUD. 207, 252 (2005) (finding that data from Texas medical malpractice claims suggested that the tort system in Texas processed these claims in a uniform way); Bernard Black, et al., *The Effects of “Early Offers” in Medical Malpractice Cases: Evidence from Texas*, 6 J. EMPIRICAL LEGAL STUD. 723, 723 (2009) (using a study of hypothetical insurance payouts on medical malpractice claims to evaluate early offer rules that would encourage defendants to settle early in medical malpractice cases); Nora Freeman Engstrom, *Sunlight and Settlement Mills*, 86 N.Y.U. L. REV. 805, 839–40 (2011) (noting how insurance practices combined with attributes of settlement mills serve to depress tort claim value); Sean J. Griffith, *Deal Insurance: Representation and Warranty Insurance in Mergers and Acquisitions*, 104 MINN. L. REV. 1839, 1875–86 (2020) (discussing how representation and warranty insurance affects contract drafting); Joanna C. Schwartz, *Police Indemnification*, 89 N.Y.U. L. REV. 885, 902–52 (2014) (studying the prevalence of indemnification in police misconduct cases and discussing its implications on deterrence and compensation); Steven C. Yeazell, *Re-financing Civil Litigation*, 51 DEPAUL L. REV. 183, 186–98 (2001) (discussing how the large expansion of consumer insurance in the United States over several decades created more opportunities for profitable litigation and thus led to changes in tort law that have substantially improved plaintiff recovery).

³ See JOHN FABIAN WITT, *THE ACCIDENTAL REPUBLIC* 71–103 (2006) (tracing the history of early industrial era industrial accident insurance and discussing how it created the patterns of thinking of later era social policy makers).

veals insurers to be, among other things, soft-law makers extraordinaire, private regulators of public police, and enablers of securities fraud.⁴

Despite this widespread use of insurance ideas, metaphors, and practices in legal thought, the dominant image of insurance that appears in legal writing is a caricature. Almost without exception, the insurance that appears in legal scholarship is an ideal type that involves the fixed-in-advance distribution of determinable risks—in which insurance companies sell protection against defined categories of losses whose total cost can be accurately predicted and, therefore, priced with confidence when insurance is sold.⁵

As any tort scholar can attest, this ideal type has great normative appeal. If insurers can accurately assess risk and price insurance on that basis, then liability insurance allows tort law to achieve in practice the deterrence and compensation objectives of tort theory. Risk-based pricing serves as the cost-internalization mechanism that provided the classic deterrence justification for strict products liability. Meanwhile the liability insurance claims process serves the compensation function, assessing and paying for tort losses and then

⁴ See generally TOM BAKER & SEAN J. GRIFFITH, *ENSURING CORPORATE MISCONDUCT* (2010) (discussing how directors' and officers' liability insurance undermines shareholder litigation); Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197 (2012) (exploring the potential value of insurance as a substitute for government regulation in consumer protection, food safety, and financial statements); John Rappaport, *How Private Insurers Regulate Public Police*, 130 HARV. L. REV. 1539 (2017) (describing how liability insurers can create meaningful change within the law enforcement agencies they insure); Shauhin A. Talesh, *Data Breach, Privacy, and Cyber Insurance: How Insurance Companies Act as "Compliance Managers" for Businesses*, 43 LAW & SOC. INQUIRY 417 (2018) (highlighting how insurance companies that offer cyber insurance influence how their policyholders comply with privacy law); Shauhin Talesh, *Legal Intermediaries: How Insurance Companies Construct the Meaning of Compliance with Antidiscrimination Laws*, 37 LAW & POL'Y 209 (2015) (suggesting that insurance companies, through regulation of policy holders, influence the meaning of antidiscrimination laws).

⁵ See, e.g., DWORKIN, *supra* note 1, at 78–79 (discussing the “value of insurance” in ways that imply a fixed-in-advance distribution of determinable risks); Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUM. L. REV. 942, 946–47 (1988) (“Insurance operates most comfortably with stochastic events, in which the probability of the frequency and magnitude of insured losses that will be suffered by a group of policyholders is highly predictable.”); Calabresi, *supra* note 1, at 529–30 (explaining how strict liability would shift unforeseeable risks in a way that could not be priced in market insurance and would become among the “uninsurable risks” that entrepreneurs would assume under a strict liability regime); Priest, *supra* note 1, at 1539–40 (“Insurance . . . requires that the loss be probabilistic, either as to whether or not it occurs at all (for example, whether one’s house burns down) or as to when the loss occurs (for example, whether one dies before or after full life expectancy).”); John W. Wade, *On the Effect in Product Liability of Knowledge Unavailable Prior to Marketing*, 58 N.Y.U. L. REV. 734, 755 (1983) (“How does one spread the potential loss of an unknowable hazard? How can insurance premiums be figured for this purpose? Indeed, will insurance be available at all?”); cf. Henry Hansmann, *The Organization of Insurance Companies: Mutual Versus Stock*, 1 J.L. ECON. & ORG. 125, 148–49 (1985) (treating the fixed-in-advance distribution of determinable risks as the ideal type for commercial insurance and explaining that the inability to satisfy this ideal type for certain risks helps to explain the strong presence of the mutual form of insurance organization in the mid-nineteenth century).

feeding those payments back into the risk assessment and pricing process. The appeal of this ideal type extends beyond tort law, however. If insurance companies sell protection against defined categories of loss whose cost can be accurately predicted and, therefore, priced with confidence when insurance is sold, then risk-based pricing is not only efficient, it is, at least in most circumstances, fair. Those prices accurately represent the expected value of the insurance to the people who buy it, such that private insurance arrangements satisfy in practice the principles of what Travis Pantin refers to as “preservative redistribution.”⁶

Legal scholars recognize that the classic information problems of adverse selection and moral hazard complicate insurers’ ability to achieve that ideal type, but those problems are typically understood as (manageable) constraints on insurers’ ability to price and select risks with precision, not as a challenge to this fundamental conception of insurance.⁷ Indeed, so well established is the fixed-in-advance, determinable-risk conception of insurance as, not only a normative ideal, but also an accurate description of how insurance actually works, that George Priest’s *Yale Law Journal* article about the 1980’s liability insurance crisis could call for the restoration of pre-1960 product liability law on the grounds that strict liability had destabilized insurance markets by undermining insurers’ ability to predict their risks.⁸ His recent challenge to the

⁶ See Travis Luis Pantin, *A Theory of Insurance Law as Preservative Redistribution* 2–3, 29 (Oct. 1, 2020) (unpublished manuscript) (on file with author) (explaining the scheme and mechanics of “preservative redistribution,” which is similar in some ways to ideas connected with “actuarial fairness,” but more carefully drawn from moral and political theory); see also Deborah A. Stone, *The Struggle for the Soul of Health Insurance*, 18 J. HEALTH POL. POL’Y & L. 287, 290 (1993) (criticizing the “actuarial fairness” vision of insurance that is similar to, but less developed than, Pantin’s preservative redistribution); cf. KENNETH S. ABRAHAM, *DISTRIBUTING RISK* 64–101 (1986) (discussing fairness and efficiency in insurance pricing).

⁷ See, e.g., Baker, *Containing the Promise of Insurance*, *supra* note 1, at 263–66 (describing tools that insurers have used to manage moral hazard); Siegelman, *supra* note 1, at 1223, 1274–77 (explaining that adverse selection is “an exaggerated threat”); Rick Swedloff, *The New Regulatory Imperative for Insurance*, 61 B.C. L. REV. 2031, 2041 (2020) (recognizing that the ideal market does not exist because of information asymmetry, but that the federal government has several of ways to counteract this problem). Put another way, the concern that moral hazard and adverse selection make insurance “reactive” and, thus, difficult to price typically operates under an assumption that there is some underlying determinable risk that can be fixed in advance if the problems of moral hazard and adverse selection can be addressed.

⁸ See Priest, *supra* note 1, at 1561–63, 1574–78 (asserting that the expansion of product liability increased the variance in liability insurance pools, relative to manufacturers’ ability to predict their risk, so that manufacturers now have greater private information about their risk than before, destabilizing the insurance market in the long term through an adverse selection unscrambling of the liability insurance market); cf. Abraham, *supra* note 5, at 976–88 (suggesting changes in environmental liability law to reduce uncertainty and promote insurance markets). Following Hansmann, *supra* note 5, Priest used the mid-1980s expansion of mutual liability insurance organizations as evidence supporting his thesis. Priest, *supra* note 1, at 1524 (attributing the changes in insurance coverage to modern tort law).

Restatement of the Law Liability Insurance makes similar arguments about the potential impact of that project on insurance markets.⁹

Scholars have persuasively criticized Professor Priest's efforts on multiple grounds, but none of those critiques took issue with the underlying description of the insurance market, which remains the implicit consensus in legal writing.¹⁰ Even scholars who would recruit insurance markets to achieve redistributive or corrective justice objectives in ways that Priest and the other "Yale lawyers" would surely regard as misguided¹¹ share their description of insurance as, fundamentally, a market that sets prices for, and then distributes, determinable risks.¹² So, too, for example, does the Supreme Court of California.¹³

There is just one field of research that seriously questions this description of insurance. Researchers in a branch of sociology initiated in the early 1990's by students of Michel Foucault have discovered insurance practices that are more varied and multi-faceted than simple loss distribution.¹⁴ Legal scholar-

⁹ See George L. Priest, *A Principled Approach Toward Insurance Law: The Economics of Insurance and the Current Restatement Project*, 24 GEO. MASON L. REV. 635, 661–62 (2017) (arguing that the drafters did not consider insurance economics when creating their proposals); see also RESTATEMENT OF LIAB. INS. (AM. L. INST. 2019). For a response, see generally Tom Baker & Kyle D. Logue, *In Defense of the Restatement of Liability Insurance Law*, 24 GEO. MASON L. REV. 767 (2017) (rebutting George L. Priest's arguments about the flaws of the *Restatement of Liability Insurance Law*).

¹⁰ For critiques of the insurance crisis article and the larger project to use insurance ideas to reduce tort liability, see, for example, Steven P. Croley & Jon D. Hanson, *The Nonpecuniary Costs of Accidents: Pain-and-Suffering Damages in Tort Law*, 108 HARV. L. REV. 1785, 1806–07 (1995); Jon D. Hanson & Kyle D. Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 CORNELL L. REV. 129, 133–137 (1990); Jane Stapleton, *Tort, Insurance and Ideology*, 58 MOD. L. REV. 820, 833–37 (1995).

¹¹ Stapleton, *supra* note 10, at 833 n.42 (using "Yale lawyers" as her term for George Priest, Alan Schwarz, and Richard Epstein, only two of whom actually taught law at Yale); see also *id.* at 837 ("The tort-as-insurance argument also generates a reform strategy which is radically redistributive whereby business is enriched and injured individuals are stripped of protection . . .").

¹² See, e.g., Tom Baker, *Health Insurance, Risk, and Responsibility After the Patient Protection and Affordable Care Act*, 159 U. PA. L. REV. 1577, 1597–1600 (2011); Allison K. Hoffman, *Three Models of Health Insurance: The Conceptual Pluralism of the Patient Protection and Affordable Care Act*, 159 U. PA. L. REV. 1873, 1883–84 (2011); Nan D. Hunter, *Risk Governance and Deliberative Democracy in Health Care*, 97 GEO. L.J. 1, 21–22 (2008).

¹³ See *Anderson v. Owens-Corning Fiberglas Corp.*, 810 P.2d 549, 559 n.14 (Cal. 1991) (en banc) ("How does one spread the potential loss of an unknowable hazard? How can insurance premiums be figured for this purpose?" (quoting Wade, *supra* note 5, at 755)) (adopting a knowability standard for liability for failure on, inter alia, insurability grounds).

¹⁴ The first significant results from this research reported in English appeared in THE FOUCAULT EFFECT: STUDIES IN GOVERNMENTALITY 35–40, 44, 197–211 (Graham Burchell, Colin Gordon & Peter Miller eds., 1991). A sample of the subsequent research includes RICHARD V. ERICSON ET AL., INSURANCE AS GOVERNANCE (2003); LUIS LOBO-GUERRERO, INSURING WAR: SOVEREIGNTY, SECURITY AND RISK (2012); RISK AND MORALITY, *supra* note 1; PAT O'MALLEY, RISK, UNCERTAINTY AND GOVERNMENT (2004); INE VAN HOYWEGHEN, RISKS IN THE MAKING: TRAVELS IN LIFE INSURANCE AND GENETICS (2007); Philip D. Bougen, *Catastrophe Risk*, 32 ECON. & SOC'Y 253 (2003); Richard V. Ericson & Aaron Doyle, *Catastrophe Risk, Insurance and Terrorism*, 33 ECON. & SOC'Y

ship has incorporated, and even extended, one of the central findings of this research: insurers often serve as private regulators of the people and entities that they insure, as illustrated most prominently in recent legal scholarship by John Rappaport's investigation of how private insurers regulate public police.¹⁵ This "insurance as governance" idea fits easily in legal scholarship because it gives shape to the moral hazard management function of liability insurance posited in Steven Shavell's influential early work on tort law and economics, and it helps explain how tort law's noisy deterrence signals translate into loss prevention efforts on the ground.¹⁶

Legal scholarship has not yet adequately acknowledged, however, let alone incorporated, a second major finding from this branch of sociological research: the ideal type of a fixed-in-advance, distribution of determinable risks does not match the reality of insurance markets. Even life insurance, which would be expected to be the paradigmatic example of this ideal type in action because of the availability of public and private mortality data going back hundreds of years, turns out to be riddled with uncertainty.¹⁷ Everywhere they looked, the sociologists found insurance practices that deviated from this ideal type: insurance that went beyond the data, potential insured losses that could easily swamp the available assets of the industry, insured losses that defied prediction, and on-the-fly, after-the-sale adjustments to unforeseen circumstance.¹⁸

135 (2004); Turo-Kimmo Lehtonen, *Picturing How Life Insurance Matters*, 7 J. CULTURAL ECON. 308 (2014); compare Michael C. Behrent, *Accidents Happen: François Ewald, the "Antirevolutionary" Foucault, and the Intellectual Politics of the French Welfare State*, 82 J. MOD. HIST. 585, 604–12 (2010) (discussing an "[a]ntirevolutionary" interpretation of Foucault through the work of François Ewald on the French welfare state); Jonathan Simon, *The Emergence of a Risk Society: Insurance, Law, and the State*, 17 SOCIALIST REV. 61, 61 n.* (1987) ("My interest in the social effects of risk management techniques was inspired by the work of Michel Foucault.").

¹⁵ See Rappaport, *supra* note 4, at 1542–50. See generally Tom Baker & Rick Swedloff, *Regulation by Liability Insurance: From Auto to Lawyers Professional Liability*, 60 UCLA L. REV. 1412 (2013) (identifying several ways insurers address adverse selection and moral hazard through their relationships with policy holders).

¹⁶ See Tom Baker & Peter Siegelman, *The Law and Economics of Liability Insurance: A Theoretical and Empirical Review*, in RESEARCH HANDBOOK ON THE ECONOMICS OF TORTS 169, 169–70 (Jennifer Arlen ed., 2013) (describing that insurers use contracts with policy holders to manage moral hazard that help give effect to the deterrence function of tort law); Steven Shavell, *On Liability and Insurance*, 13 BELL J. ECON. 120, 127 (1982) (noting that liability insurers can monitor prevention action and structure terms depending on that level of activity); cf. Kenneth S. Abraham, *Four Conceptions of Insurance*, 161 U. PA. L. REV. 653, 683–97 (2013) (describing "insurance as governance" as one of the four conceptions of insurance).

¹⁷ RICHARD V. ERICSON & AARON DOYLE, *UNCERTAIN BUSINESS: RISK, INSURANCE AND THE LIMITS OF KNOWLEDGE* 46–94 (2004) (discussing the uncertainty underlying life insurance).

¹⁸ See *id.* (noting uncertainty in multiple areas of insurance). For an insightful, insurance-industry-insider account of the uncertainty that permeates the insurance business, see generally Sean

This Article brings this second finding and the challenge it poses into legal scholarship, while also extending the underlying qualitative empirical research, by investigating, for the first time in the scholarly literature in any field, the rise of insurance runoff, a thriving sector of the insurance market whose *raison d'être* has been managing losses that proved to be indeterminable.¹⁹ In combination with the sociological research just described, the research reported in this Article challenges the descriptive accuracy of the prevailing insurance ideal type, as well as the legal and policy conclusions that depend on that descriptive accuracy.²⁰ Insurers may well try to price based on their best assessment of the frequency and severity of future losses,²¹ but the sociological research provides so many reasons why insurers so rarely hit that pricing nail on the head that legal scholars should stop thinking and acting as if insurers regularly could do so.²² Instead, we should start learning more about how insurers manage the uncertainty that the research reveals.

M. Fitzpatrick, *Fear Is the Key: A Behavioral Guide to Underwriting Cycles*, 10 CONN. INS. L.J. 255 (2004) (highlighting the role that human behaviors play in underwriting cycles).

¹⁹ See *infra* notes 38–225 and accompanying text. Perhaps surprisingly, this Article is also the first examination in legal scholarship of the mergers and acquisitions side of the insurance industry. Sean Griffith's recent, notable research on representations and warranties insurance examines the emerging role of insurance in facilitating mergers and acquisitions, but not the M&A side of the insurance industry itself. See generally Griffith, *supra* note 2 (examining how transacting parties use representations and warranties insurance). For legal and actuarial practitioner articles about insurance runoff, see, for example, David Whear & Bob Haken, *Closing Books of Business: The Challenge of Fairness and Finality*, in RESEARCH HANDBOOK ON INTERNATIONAL INSURANCE LAW AND REGULATION 167 (Julian Burling & Kevin Lazarus eds., 2011); Stephen Carter et al., *Exit Strategies in the Run-off Market*, 56 FED'N DEF. & CORP. COUNS. Q. 219, 221 (2006); Jason L. Russ & Thomas A. Ryan, *The Runoff Environment—Considerations for the Reserving Actuary*, CAS. ACTUARIAL SOC'Y F., Fall 2002, at 287, <http://www.casact.org/pubs/forum/02fforum/02ff287.pdf> [<https://web.archive.org/web/20201002164707/http://www.casact.org/pubs/forum/02fforum/02ff287.pdf>].

²⁰ See, e.g., Priest, *supra* note 1, at 1539–40 (asserting that some tort liability must be walked back to help stabilizing the insurance market in the long term from adverse selection); James C. Cooper & Bruce H. Kobayashi, *An Unreasonable Solution: Rethinking the FTC's Current Approach to Data Security* 28–31 (Geo. Mason Univ. L. & Econ. Rsch. Paper Series, 20-23, 2020) (calling for strict liability for data breaches so that insurers can function as private regulators of cyber security by using insurance prices to encourage people or businesses to engage in efficient loss prevention).

²¹ See, e.g., LOBO-GUERRERO, *supra* note 14, at 6–7 (discussing the use of a reasonable calculus); cf. Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 489–90 (2007) (describing how directors' and officers' insurers attempt to price based on risk).

²² For examples of legal scholarship that treat tort law rules that make hitting that nail on the head more difficult as a problem that suggests lawmakers should do something, see, for example, Mark A. Geistfeld, *Legal Ambiguity, Liability Insurance, and Tort Reform*, 60 DEPAUL L. REV. 539, 549 (2011) (describing the insurance underwriting cycle as the product of “forecasting errors” attributable to “legal ambiguity” and arguing that “[t]he protection of individual tort rights in mass markets has led to a marked increase in legal ambiguity.”); Priest, *supra* note 1, at 1561–63, 1574–78 (arguing that the rise of increased tort liability led to the 1980s liability insurance crisis); and, arguably, see also

The Article begins in Part I with an etymology of the word “runoff” as used in the insurance context to refer to the practice of winding down—running off—insurers’ obligations under their old insurance policies.²³ Then, in Part II, the Article describes a thriving new market in those old obligations that first developed in the years following the most famous insurance runoff transaction in modern times: Lloyd’s Reconstruction and Renewal.²⁴ Together with a set of similar transactions that took place at about the same time on this side of the Atlantic, the Reconstruction and Renewal set the stage for the consolidation of problematic, legacy insurance obligations in entities that do not sell new insurance policies.²⁵ More recently, this insurance runoff market has expanded beyond liability insurance to include other long-duration insurance products that have not worked out well for the insurance companies that sold them.²⁶

Tom Baker, *Insuring Liability Risks*, 29 GENEVA PAPERS ON RISK & INS. 128, 142–43 (2004) (describing how legal uncertainty poses a threat to the insurability of liability risks).

²³ See *infra* Part I and accompanying text.

²⁴ See *infra* Part II and accompanying text. This 1996 transaction reinsured all of Lloyd’s obligations under non-life policies issued before 1993—most significantly asbestos, pollution, and other toxic tort liabilities—into a newly formed entity, Equitas, designed to honor those obligations as they became due over the next fifty (or more) years, allowing Lloyd’s to continue as a major force in insurance markets. NAT’L ASS’N OF INS. COMM’RS EXAMINATION TEAM TO THE SURPLUS LINES (E) TASK FORCE, LLOYD’S: A REVIEW BY U.S. STATE INSURANCE REGULATORS 7, 10–11 (1998) [hereinafter NAIC LLOYD’S REPORT], http://www.uniset.ca/lloyddata/Lloyds_Report_Final_091498.pdf [<https://perma.cc/4KCQ-NZJN>].

²⁵ See LIAB.-BASED RESTRUCTURING WORKING GRP. OF THE NAIC FIN. CONDITION (EX4) SUBCOMM., LIABILITY-BASED RESTRUCTURING WHITE PAPER § VII (1997) [hereinafter LIAB.-BASED RESTRUCTURING WHITE PAPER] (noting the advantages of liability-based restructurings and promoting their use).

²⁶ See, e.g., CNO Fin. Grp., Inc., Current Report (Form 8-K) (Sept. 27, 2018) (reporting a \$3.525 billion runoff transaction between Bankers Life and Casualty Company and Wilton Reassurance Company for legacy nursing home and comprehensive long-term-care business); PRICEWATERHOUSECOOPERS, EUROPEAN LIFE INSURANCE BACK BOOK MANAGEMENT 2017 (2018), <https://www.pwc.co.uk/audit-assurance/assets/pdf/european-life-book-survey-2017.pdf> [<https://perma.cc/99GT-KFDA>] (describing growth of life and annuity runoff transactions); Ben Gonson, *Is Long-Term Health Care the Next Run-off?* AIRROC MATTERS, Winter 2016–2017, at 19, 19–20 (noting the high uncertainty of long-term-care insurance and the high interest this has created in runoff of these policies); see also Affidavit of Professor Tom Baker at 64–71, ABN AMRO Bank N.V. v. Dinallo, 962 N.Y.S.2d 854 (App. Div. 2013) (No. 601846/09) (reporting that reinsurance transactions have been used by financial guaranty insurance companies and offering illustrative examples). The companies that assume and manage these legacy obligations serve as what we might call “uncertainty sinks,” combining the “uncertain business” metaphor used by sociologists Richard Ericson and Aaron Doyle with the “ultimate sink” metaphor used by the historian Joel Tarr. ERICSON & DOYLE, *supra* note 17, at 5, 47 (identifying insurance as the titular “uncertain business” and noting that it is “the very business that is charged with transforming uncertainty into [manageable] risk”); JOEL A. TARR, THE SEARCH FOR THE ULTIMATE SINK: URBAN POLLUTION IN HISTORICAL PERSPECTIVE, at xlii (1996) (examining the economic concept that firms will seek a sink in which to protect against their externalities, and expanding it to urban and environmental issues). Using Knight’s distinction between risk and uncertainty, Ericson and Doyle showed how the limits of knowledge and the competitive nature of the insur-

Part III of this Article describes how that transformation takes place.²⁷ This requires delving into some unavoidably technical subjects—runoff underwriting, policy management, asset management, and finance—that are the subject of the first half of Part III.²⁸ This description represents the first serious effort to explain the insurance runoff market to a general audience. Understanding the runoff market also, and perhaps more importantly, requires developing an appreciation for the role of rhetoric and organizational structure in this process.

Prior research has documented that “[i]nsurance companies tell two different sets of stories about insurance at two distinct points in the insurance relationship.”²⁹ As the second half of Part III describes for the first time, the runoff market features another set of stories, told by people in another organizational location.³⁰ The runoff stories valorize finality, compromise, and innovation over the protection, dependence, and contract of the sales and claims stories, and they help insurers avoid the obvious criticism that they simply made a bad bet. If the sales stories help sell an important product that not enough people otherwise would buy, and the claims stories help people accept that insurance protection must have limits, then these runoff stories may help people understand that insurance markets need room for after-the-fact accommodation and adjustment, and that there can be circumstances in which the insurance

ance business push insurers beyond the domain of risk (where uncertain individual losses become predictable in the aggregate) into the domain of uncertainty (where losses are not predictable even in the aggregate). ERICSON & DOYLE, *supra* note 17, at 46–93 (explaining how uncertainty pervades even the life insurance market and identifying methods by which insurance companies have managed this uncertainty while continuing to provide coverage); FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT 22–51 (1921) (delineating between risk, which can be measured by profitability, and uncertainty, which cannot be measured); *see also* Geistfeld, *supra* note 22, at 540–41 (explaining that legal ambiguity contributes to uncertainty in this sense). Insurance runoff transactions typically involve losses that, we now know, were uncertain in this larger, aggregate sense at the time the original insurance policies were sold. The insurance runoff market transforms those past uncertainties into today’s tradable risks and transfers them to specialists—the uncertainty sinks—to manage.

²⁷ *See infra* Part III and accompanying text.

²⁸ *See infra* notes 98–168 and accompanying text.

²⁹ Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1397 (1994). Insurance companies minimize the potential for these “sales” and “claims” stories to come into direct conflict by separating the organizational arm tasked with explaining each of them. *Id.* at 1415–17. The sales stories stress the dependence of policyholders and the protection that insurance provides; the claims stories stress the contractual nature of the relationship and the limits of that insurance protection. *Compare id.* at 1403–07 (describing themes of dependency and trust), *with id.* at 1408–11 (describing themes of insurance as contract and the need to protect the insurance fund for the future and from fraudulent claims). Note that there is another reason for separating the claims and underwriting departments that cuts in the other direction: underwriting could pressure the claims department to delay or deny certain claims to improve the underwriting ratio on a book of business. Thank you to Sean Fitzpatrick for this observation.

³⁰ *See infra* notes 169–202 and accompanying text.

industry's ordinary approach to promise and contract can be suspended, precisely to permit that ordinary approach to be maintained more generally.

Although the research reported in this Article provides significant new insight into how insurers use the runoff market to manage uncertainty,³¹ it is important not to exoticize insurance runoff transactions. The dynamic that produced the insurance runoff market is as old as the insurance business. Insurers have always extended protection against losses whose frequency and magnitude were unknown, whether by engaging in the obviously innovative act of creating a new insurance product to cover a new set of risks (happening with cyber and digital asset insurance today³²), by revising a standard-form insurance policy, or, even, by continuing to sell exactly the same insurance policies in the real-world insurance market.³³ Competition among insurers changes the shape of the insurance market, the creative destruction of the underlying insured activity changes the risks transferred in that market, and there is always the possibility of change in the governing legal rules.³⁴ In practice, there is no such thing as the fixed-in-advance distribution of fully determinable risks.³⁵ Insurance is an uncertain business.³⁶

It is time for legal thought to update its insurance ideas and metaphors, and its use of insurance practices, to this more realistic understanding of insur-

³¹ See *infra* notes 203–225 and accompanying text.

³² See, e.g., Tom Baker, *Back to the Future of Cyber Insurance*, PLUS J., Q3 2019, at 4, 5 (providing preliminary answers to the question, “[h]ow have insurers managed for over twenty years to sell insurance against cyber risks that their underwriters don’t (and can’t) fully understand?”); Adam Zuckerman, *Bitcoin Insurance? The Emerging Market for Digital Asset Insurance*, PLUS J., Q2 2020, at 8, 12 (remarking on the market for digital asset insurance regardless of the general uncertainty in the area).

³³ See, e.g., ERICSON & DOYLE, *supra* note 17, at 212–84 (describing their thesis that uncertainty is everywhere and thus insurance is an uncertain business); Dwight M. Jaffee & Thomas Russell, *Catastrophe Insurance, Capital Markets, and Uninsurable Risks*, 64 J. RISK & INS. 205, 207 (1997) (describing—in a more nuanced understanding of insurance than typically reflected in law and economics literature—how marine insurers historically addressed large, uncertain losses); see also Dwight Jaffee, *Monoline Restrictions, with Applications to Mortgage Insurance and Title Insurance*, 28 REV. INDUS. ORG. 83, 105–06 (2006) (explaining that monoline insurance manages cases of extreme loss through insolvency and that legal rules requiring certain kinds of insurance to be conducted through monoline insurance protect the larger insurance pool from that risk of extreme loss). As Ericson and Doyle have shown, even selling a tried and true insurance policy into a well-established market can be a voyage into uncertainty, because of the dynamism of insurance markets and insured risks. ERICSON & DOYLE, *supra* note 17, at 47 (“Beneath the veneer of certainty, life insurance is a very uncertain business.”).

³⁴ ERICSON & DOYLE, *supra* note 17, at 46–93; see also Baker, *supra* note 22, at 133–34 (discussing “[l]egal developments risk”); cf. KARL POLANYI, *THE GREAT TRANSFORMATION*, at xxviii (Beacon Press 2d ed. 2001) (1944) (positing that even purely laissez-faire proponents inevitably react in a regulatory way to protect from uncertainty in times of economic downturn).

³⁵ See Fitzpatrick, *supra* note 18, at 260 (“[T]he bottom line is that pricing uncertainty [is] . . . built into the very nature of insurance.”).

³⁶ ERICSON & DOYLE, *supra* note 17, at 47.

ance. Insurance markets always and everywhere trade in uncertainty, and insurance markets always and everywhere develop ways to transform that uncertainty into manageable risk. With this more realistic understanding of insurance, legal thought can lessen its concern about the impact of legal change on insurance markets, even if we regard those markets as essential, because we can be more confident that those markets will manage through legal change.³⁷

I. AN ETYMOLOGY OF INSURANCE RUNOFF

The insurance usage of “runoff” can be traced back at least as far as the 17th century marine insurance market at Lloyd’s coffee shop.³⁸ At Lloyd’s, individual merchants agreed to underwrite a share of the risks of a voyage, in return for a share of the insurance premium. They earned their share as soon as they had “run” the risk, meaning that the ship sailed.³⁹ Once the voyage was over and any claims paid, the risk was fully “run” and the potential liability came “off” the portion of the merchant’s ledger book that listed liabilities, with the difference between the premium and any claim payments recorded as profit or loss.⁴⁰ This accounting process became known as “running off” the risk, a feature of insurance accounting that continues today.⁴¹

Over time, the underwriters working at Lloyd’s organized syndicates that underwrote risks for their members (including passive investors, known as Names) for a period of one year.⁴² At the end of three years (the year in which policies were sold plus two years), a syndicate would close by reinsuring with a new syndicate all the risks that had not already run off and declaring and distributing the profit (or loss) to its members.⁴³ This process became known as

³⁷ Cf. *Anderson v. Owens-Corning Fiberglas Corp.*, 810 P.2d 549, 557–59, 561–63 (Cal. 1991) (en banc) (explicitly structuring the warning defect aspect of product liability law so that it “rings of negligence” because truly strict liability would inefficiently make distributors the insurers of their own products, with a partial dissent from the last remaining justice of the California Supreme Court from the expansive Traynor era, Justice Stanley Mosk).

³⁸ See generally CHARLES WRIGHT & C. ERNEST FAYLE, *A HISTORY OF LLOYD’S: FROM THE FOUNDING OF LLOYD’S COFFEE HOUSE TO THE PRESENT DAY* (1928) (telling the story of the rise, development, and operation of Lloyd’s).

³⁹ JAMES ALLAN PARK, *A SYSTEM OF THE LAW OF MARINE INSURANCES: WITH THREE CHAPTERS ON BOTTOMRY; ON INSURANCES ON LIVES; AND ON INSURANCES AGAINST FIRE* 367–68 (1790) (“The principle, upon which the whole of this doctrine depends, is simple and plain, admitting of no doubt or ambiguity. The risk or peril is the consideration for which the premium is to be paid: if the risk be not run, the consideration for the premium fails . . .”).

⁴⁰ JOSEPH MARRYAT, *OBSERVATIONS UPON THE REPORT OF THE COMMITTEE ON MARINE INSURANCE* 50–51 (2d ed. 1810).

⁴¹ See, e.g., Russ & Ryan, *supra* note 19, at 288–89.

⁴² NAIC LLOYD’S REPORT, *supra* note 24, at 29.

⁴³ *Id.* at 5. This three-year cycle was born from: the one year of active underwriting and a two-year runoff period in which the syndicate waited for the risk to run and pay out any claims. *Id.* at 28.

“reinsurance to close,” and the new syndicate that offered the reinsurance to close often included some or all of the same underwriters and Names as the closing syndicate.⁴⁴ The original syndicate retained a formal contractual relationship with the merchants it insured, but the reinsurance-to-close transaction assigned all the responsibilities for that relationship to the new syndicate.⁴⁵ As long as that new syndicate fulfilled those responsibilities, the merchants who purchased insurance from Lloyd’s syndicates could safely remain oblivious to the opening and closing of the syndicates that issued the policies sold at Lloyd’s.

Occasionally, a syndicate would be unable to reinsure to close, presumably because the underwriters and Names were unwilling (or unable) to form a new syndicate that would reinsure the old syndicate to close, and they were unwilling (or unable) to pay the reinsurance-to-close premium that other syndicates demanded.⁴⁶ Such syndicates remained “open,” and they could not close until all the risks had run off or they found a syndicate willing to reinsure-to-close at a price that the members were able and willing to pay.⁴⁷ The only business of a syndicate that remained open after three years, then, was running off the risks and seeking reinsurance-to-close. The open syndicate was said to be “in runoff,” a use of that term that continues through today.⁴⁸

By at least the 19th century, the concept of runoff and its association with reinsurance were accepted aspects of insurance market practice generally, not just at Lloyd’s.⁴⁹ Like the open syndicates at Lloyd’s, insurers that stopped underwriting entirely were said to be in runoff, and when an insurer stopped underwriting in a market, whether defined geographically or by type of insurance, that part of the insurer’s business was said to be in runoff as well. As at Lloyd’s, one insurance company might agree to take over the business of an-

⁴⁴ *Id.* at 5, 18, 22–23, 28 (describing the three-year accounting system, reinsurance-to-close, and the security of tenure of Names in their respective syndicates). To be clear, there would be no dollar limit on the reinsurance to close. *See id.* at 22–23, 28.

⁴⁵ *Id.* at 5, 18, 22–23, 28.

⁴⁶ *See* Carolyn Aldred, *Lloyd’s to Make First Claim on Central Fund’s Cover; Claim Will Exhaust Reinsurance Program’s Annual Limit*, BUS. INS., Aug. 12, 2002, at 17 (describing an inability to reinsure after the financial uncertainty caused by 9/11). For example, a member of the syndicate who has declared bankruptcy or is insolvent would have no interest in paying additional premiums to close a syndicate. And because the other members are liable only for their shares, they wouldn’t have the same incentive to reinsure to close that they would have if they had full liability.

⁴⁷ *See id.* (describing a “surge” in open years at Lloyd’s following the September 11 attacks).

⁴⁸ *See, e.g.*, WRIGHT & FAYLE, *supra* note 38, at 25, 197; NAIC LLOYD’S REPORT, *supra* note 24, at 25.

⁴⁹ *See, e.g.*, *Reports of Meetings.: City of London Marine Insurance Corporation, Limited.*, MONEY MKT. REV., Feb. 11, 1888, at 266 (1888) (reporting amounts underwritten, “run off or been reinsured,” and remaining liabilities).

other through a reinsurance transaction in which the acquiring insurer reinsured the risks in runoff.⁵⁰

II. THE LLOYD'S RENEWAL AND RECONSTRUCTION

Lloyd's continued to operate on this traditional basis into the mid-1990s.⁵¹ As a formal matter, Lloyd's became a membership organization whose members participated in syndicates that issued insurance policies.⁵² Neither Lloyd's itself nor any other corporate entity was financially responsible for the payment of claims.⁵³ Instead, Lloyd's was a central administrative apparatus that managed claims but had no formal financial obligation for those claims.⁵⁴ In form, the Lloyd's administration simply connected policyholders with the syndicates, which were composed of individuals, that issued their policies. The "Names" in the syndicates had unlimited liability, but only for their share of the obligations of their syndicates, not for the syndicate as a whole.⁵⁵

Traditionally, the Lloyd's administration managed that unlimited liability through the reinsurance-to-close transaction just described.⁵⁶ Because of mounting asbestos and environmental liability and catastrophic property losses on policies written in the 1980s and earlier, however, an increasing number of syndicates faltered in the 1980s and were unable to find newer syndicates to reinsure their obligations, thus remaining open syndicates.⁵⁷ Names, many of whom only recently participated in Lloyd's for the first time as Lloyd's broadened its membership starting in the late 1970s, were hit with severe losses, in many cases several times the payments they made to Lloyd's to become members and invest in the business.⁵⁸ Names began to default in mass (*de facto* if

⁵⁰ Lee R. Steeneck, *Loss Portfolios: Financial Reinsurance*, 72 PROC. CASUALTY ACTUARIAL SOC'Y 154, 154–56, 156 n.2 (1985) (providing the history and business purposes of loss portfolio transfers and describing a 16th-century transaction).

⁵¹ NAIC LLOYD'S REPORT, *supra* note 24, at 8–11, 16.

⁵² *Id.* at 16. As described in WRIGHT & FAYLE, *supra* note 38, at 422–23, it was not until the incorporation of Lloyd's in 1871 that Lloyd's formally adopted different rules for members who directly engaged in underwriting and the "Names" who were passive members of the syndicate and interacted with Lloyd's through an agent.

⁵³ NAIC LLOYD'S REPORT, *supra* note 24, at 4 ("Lloyd's is a market, not an insurer.").

⁵⁴ *Id.* at 5, 19–22.

⁵⁵ *Id.* at 8.

⁵⁶ *Id.* at 5; *supra* notes 42–45 and accompanying text (explaining the origins of reinsurance-to-close transactions).

⁵⁷ See Lawrence Ingrassia & Dana Milbank, *Market at Risk: Hit by Huge Losses, Lloyd's of London Struggles to Survive—Insurance Exchange Seeks to Raise Money and End Disputes with Investors—'It's Like a Rubik's Cube,'* WALL ST. J., May 15, 1995, at A1.

⁵⁸ *Id.*

not *de jure*), undermining confidence in the Lloyd's market.⁵⁹ Warren Buffett colorfully described this process as follows in his 2006 Letter to Shareholders:

Eventually, the names came to include many thousands of people from around the world, who joined expecting to pick up some extra change without effort or serious risk. True, prospective names were always solemnly told that they would have unlimited and everlasting liability for the consequences of their syndicate's underwriting—"down to the last cufflink," as the quaint description went. But that warning came to be viewed as perfunctory. Three hundred years of retained cufflinks acted as a powerful sedative to the names poised to sign up.

Then came asbestos. When its prospective costs were added to the tidal wave of environmental and product claims that surfaced in the 1980s, Lloyd's began to implode. Policies written decades earlier—and largely forgotten about—were developing huge losses. No one could intelligently estimate their total, but it was certain to be many tens of billions of dollars. The specter of unending and unlimited losses terrified existing names and scared away prospects. Many names opted for bankruptcy; some even chose suicide.

From these shambles, there came a desperate effort to resuscitate Lloyd's. In 1996, the powers that be at the institution allotted £11.1 billion to a new company, Equitas, and made it responsible for paying all claims on policies written before 1993. In effect, this plan pooled the misery of the many syndicates in trouble. Of course, the money allotted could prove to be insufficient—and if that happened, the names remained liable for the shortfall.⁶⁰

This "desperate effort" was known as Lloyd's Reconstruction and Renewal.⁶¹ Through a series of transactions that the United Kingdom Department of Trade and Industry scrutinized and the United States regulators subsequently acquiesced to, underwriters, Names, and their agents paid a reinsurance premium, and the newly formed Equitas agreed to receive, process, and pay any claims

⁵⁹ See *id.*

⁶⁰ Letter from Warren Buffett, Chairman of Berkshire Hathaway Inc., to S'holders of Berkshire Hathaway Inc. (Feb. 28, 2007), in BERKSHIRE HATHAWAY INC., 2006 ANNUAL REPORT 9 (2007), <https://www.berkshirehathaway.com/2006ar/2006ar.pdf> [<https://perma.cc/E5AK-BUD7>].

⁶¹ See NAIC LLOYD'S REPORT, *supra* note 24, at 10–11 (describing the Reconstruction and Renewal); Letter from Warren Buffett, *supra* note 60. For a high-level, insider description of the reconstruction and renewal (R&R), see Mike Palmer, *The Deal of the Decade*, AIRROC MATTERS, Summer 2007, at 30, 30–32; LLOYD'S LTD., RECONSTRUCTION AND RENEWAL BYELAW 5–13 (1995), https://www.lloyds.com/~media/files/the-market/operating-at-lloyds/regulation/acts-and-byelaws/byelaws/reconstructionandrenewal_byelaw.pdf [<https://perma.cc/Q5BL-43HH>].

on the reinsured legacy business, subject only to the terms and conditions of the original insurance policies and without regard to the total costs that Equitas might be obligated to pay.⁶² In effect, Equitas issued a massive reinsurance-to-close policy covering obligations under all policies issued before 1993.

By reinsuring all old business into Equitas (except for life insurance, which could not be reinsured as Equitas did not qualify as a life insurer under English law), Lloyd's effectively created Equitas to function as an "old Lloyd's" comprised of all pre-1993 business.⁶³ Equitas was separate from the "new Lloyd's" that would house the ongoing and active syndicates for years 1993 and beyond.⁶⁴ The Lloyd's restructuring separated the legacy business from Lloyd's ongoing business, improving the syndicates' ability to continue selling insurance.

To the extent that Equitas simply reinsured the old, open syndicates to close, Lloyd's Reconstruction and Renewal could be seen to differ from Lloyd's traditional runoff arrangements only in scale. Yet it also differed significantly in kind. First, by reinsuring to close all the open syndicates into a single entity, Equitas, it facilitated a broader socialization of losses among the Names than the individualized, syndicate-by-syndicate reinsurance-to-close process.⁶⁵ Second, Equitas did not simply reinsure to close all the old open syndicates. Equitas also reinsured the pre-1993 liabilities of the syndicates that had been able to reinsure to close, thereby taking those legacy liabilities off the books of any active syndicates.⁶⁶ This meant that the Equitas transaction split the liabilities of the 1993 and later syndicates, many of which carried liabilities

⁶² NAIC LLOYD'S REPORT, *supra* note 24, at 10–11, 49, 51–54 (reporting the formation and operation of Equitas as well as how it provided relief for legacy business); Lisa S. Howard, *Lutine Bell Tolls Relief for Lloyd's*, NAT'L UNDERWRITER PROP. & CAS.-RISK & BENEFITS MGMT., Sept. 9, 1996, at 1, 1 (stating that the New York Insurance Department had approved the transfer of \$5.5 billion from the Lloyd's American Trust Fund into Equitas).

⁶³ See NAIC LLOYD'S REPORT, *supra* note 24, at 10, 51.

⁶⁴ Press Release, Equitas Ltd., Equitas Receives Go-Ahead (Sept. 4, 1996). The contractual mechanism by which policies were reinsured into Equitas defined and separated every existing syndicate's policy liabilities into two groups based upon whether the policy could incur a liability that was written during or before the 1992 year of account. See *In re The Names at Lloyd's for the 1992 & Prior Years of Acct.*, [2009] EWHC (Ch) 1595, [1]–[4] (UK), 2009 WL 1949482.

⁶⁵ See *In re The Names at Lloyd's*, [2009] EWHC (Ch) 1595, at [4] (noting that Equitas reinsured the liabilities of 1992 and prior business for all open non-life insurance syndicates).

⁶⁶ See *id.* (describing that Equitas also reinsured the pre-1993 liabilities for all closed non-insurance syndicates that were reinsured into any open syndicates). Disappointed policyholders that previously had been protected by reinsurance-to-close could not proceed against those active syndicates, because Lloyd's reinsurance-to-close transactions (like reinsurance generally) obligate the reinsuring syndicate to manage the liabilities for the benefit of the original syndicate; they do not give the policyholder of the original syndicate any rights directly against a syndicate that provided reinsurance-to-close. See *id.* at [9] (noting that open syndicates would still be responsible to policy holders if they were directly liable).

for pre-1993 policies that they had reinsured-to-close.⁶⁷ Finally, unlike the prior entities that had offered reinsurance to close, Equitas went into runoff at inception, so there was never a possibility that profits from the active business could help pay claims under the old policies.

As Buffett's letter described, the Lloyd's/Equitas transaction did not, as a formal matter, legally separate the legacy obligations from the ongoing business.⁶⁸ Policyholders could still legally proceed against the original syndicates and, if the syndicates did not pay, assess the Names individually for any deficiency not paid by Equitas.⁶⁹ Yet, because of the unique form of Lloyd's business—in which the contractual obligations of the syndicates that issued the insurance policies reduce to pro rata obligations of the individual members of the syndicates rather than an insurance company with a permanent life—it was understood that collecting from the original syndicates at some uncertain point in the future would be unlikely.⁷⁰ Many Names in the older syndicates already were deceased, with their estates already probated, and, thus, no longer a potential source of funds, and many more would be deceased by the time that Equitas ran out of money (if it ever did). Moreover, the Names that remained at that time could well be living all over the world and, in many if not most cases, out of reach without the cooperation of the Lloyd's administration. And that administration appears to have decided that, with respect to the liabilities of the Names who participated in Equitas, it had done everything necessary to protect policyholders by creating Equitas.⁷¹ This *de facto* legal separation became *de jure* when subsequently enacted legislation preempted contract law in this case and permitted the transfer of liabilities from the issuing syndicates to

⁶⁷ See *id.* at [1]–[4] (describing how the transaction separated the pre-1993 liabilities from those from 1993 and beyond). Responsibility for managing the claims of policyholders insured under old policies that had already been reinsured-to-close into post-1992 syndicates were transferred to Equitas whereas policyholders insured under new policies covered by those same post-1992 syndicates remained under Lloyd's direct care. See *id.*

⁶⁸ Letter from Warren Buffett, *supra* note 60, at 9 (“Of course, the money allotted [to Equitas] could prove to be insufficient—and if that happened, the names remained liable for the shortfall.”).

⁶⁹ NAIC LLOYD'S REPORT, *supra* note 24, at 53–54; David L. Foster, *Equitas and the New Lloyd's: Practical Implications for Policyholders, Brokers, and Reinsurers*, METRO. CORP. COUNS., May 1997, at 10, 10.

⁷⁰ See NAIC LLOYD'S REPORT, *supra* note 24, at 53–54 (reporting that if Equitas ran out of funds U.S. policyholders could recover directly, but this would be time consuming and costly); Foster, *supra* note 69 (describing the litigation uncertainties that could arise if Equitas ran out of funds); Stacy Shapiro, *Policyholders Called Key to Lloyd's Future*, BUS. INS., June 5, 1995, at 42, 42 (noting the claimants would have little chance of recovery if Equitas failed).

⁷¹ Cf. Stephanie Strom, *The Financial Safety Net Is Almost Spread Beneath Lloyd's: But Questions Persist on Risks of Reinsurance*, N.Y. TIMES, Aug. 22, 1996, at D1 (explaining that if Equitas could not satisfy a claim a policyholder would have to undertake the “impossible” task of suing the Names directly and, regardless, noting that Lloyd's chief executive, Ron Sandler, was satisfied with a blessing from the British Department of Trade).

Equitas without the acquiescence of policyholders, provided that the United Kingdom High Court of Justice approved the transaction.⁷² The High Court did so in 2009, completing the legal separation of the obligations under the pre-1993 Lloyd's policies from the syndicates that issued or reinsured them.⁷³

Along with a set of similar insurance company restructuring transactions that took place in the United States at about the same time, Lloyd's Reconstruction and Renewal paved the way for runoff transactions to become a distinct sector of the insurance market.⁷⁴ These U.S. transactions included: the restructuring of the property and casualty business of the Insurance Company of North American (usually referred to as INA, which, by then, was part of CIGNA) through a series of transactions that culminated in the formation of a runoff entity known as Brandywine in 1995; the restructuring of the Crum & Forster Group in 1993 that facilitated the exit of Crum & Forster's then parent, Xerox, from the insurance business; the restructuring of ITT-Hartford in 1992 that placed several Hartford subsidiaries into runoff and facilitated the exit of ITT from the insurance business; and the 1994 restructuring and eventual winding down of The Home Insurance Company, pursuant to which Zurich Insurance Group acquired the valuable parts of The Home Insurance Company's business.⁷⁵

These transactions became known as the asbestos, pollution, and health hazard (APH) liability-based restructurings.⁷⁶ They paved the way for a broader separation of legacy APH obligations from the active parts of the property and casualty insurance industry. Since the 1990s, runoff specialists, most prominently Berkshire Hathaway's National Indemnity Company (NICO), have come to manage an increasingly large percentage of legacy APH obligations.⁷⁷ NICO reinsured all of Equitas's liabilities in 2006 in return for acquiring all of Equitas's assets (hence, Buffett's discussion of Lloyd's in his 2006

⁷² Financial Services and Markets Act 2000, c. 8, § 111 (UK).

⁷³ *In re The Names at Lloyd's for the 1992 & Prior Years of Acct.*, [2009] EWHC (Ch) 1595, [39] (UK).

⁷⁴ LIAB.-BASED RESTRUCTURING WHITE PAPER, *supra* note 25.

⁷⁵ *Id.* at app. 1; see also Jonathan Rosen, *The Home Insurance Company—A Brief History of Time*, AIRROC MATTERS, Summer 2011, at 6, 6–7 (providing a history of The Home Insurance Company including a discussion of the complex transaction that led to Zurich Insurance Group acquiring parts of The Home Insurance Company's business).

⁷⁶ See LIAB.-BASED RESTRUCTURING WHITE PAPER, *supra* note 25, § I.

⁷⁷ See STATE OF NEB. DEP'T OF INS., EXAMINATION REPORT OF NATIONAL INDEMNITY COMPANY AS OF DECEMBER 31, 2016, at 12, 17–19, 20–22 (2018) (noting that reinsurance is the primary business and listing transactions); Tim Zawacki, *Berkshire Unit's Retroactive Reinsurance Biz Expands with Ironshore Cover*, S&P GLOB. MKT. INTEL. (Dec. 5, 2017), https://www.spglobal.com/marketintelligence/en/news-insights/trending/l_yjh8pgbqn8dg8zhsegzw2 [<https://perma.cc/QM4K-CWRH>] (reporting that National Indemnity's amount of reinsurance for retroactive adverse coverage had increased to around forty billion dollars).

letter), and it reinsured APH obligations of, among other insurance groups, INA (since sold by CIGNA to Chubb along with the rest of CIGNA's property casualty subsidiaries), CNA, AIG, Liberty Mutual, and The Hartford through conceptually similar transactions.⁷⁸ Other active runoff specialists with significant stakes in APH obligations as of 2019 include Armour, Catalina, Enstar, CompRe, and Randall & Quilter.⁷⁹ The insurance industry's asbestos and environmental liability experience is not over, but the center of gravity has shifted decidedly toward the runoff specialists, and the share of liability insurers' reserves represented by asbestos and environmental liabilities is trending steadily down.⁸⁰

III. INSURANCE RUNOFF: MECHANICS AND STORIES

With the growth of the APH insurance runoff market came a cadre of experienced managers of runoff businesses, trade associations, and practice groups in accounting and law firms that specialize in the acquisition and solvent runoff of legacy obligations of insurers, initially focusing on property casualty lines of insurance but then expanding to life and health insurance lines.⁸¹ There had long been a need for insurance transactions and procedures that facilitate the relatively infrequent runoff of *insolvent* insurance companies.⁸² What was new was the extension and expansion of that transactional practice into the much larger field of *solvent* insurance runoff.⁸³

⁷⁸ See, e.g., Letter from Warren Buffett, *supra* note 60, at 7–10 (describing National Indemnity's reinsurance contract with Equitas). Berkshire Hathaway's insurance investments include a huge stake in insurance runoff. See STATE OF NEB. DEP'T OF INS., *supra* note 77 (noting National Indemnity's prevalence in the reinsurance market and listing transactions); cf. Mark J. Roe, *Foundations of Corporate Finance: The 1906 Pacification of the Insurance Industry*, 93 COLUM. L. REV. 639, 681 (1993) (discussing how the Armstrong investigation and its fallout resulted in effects that continue to shape how the insurance industry manages investments today, most notably by rarely holding large positions of corporate stocks).

⁷⁹ See PRICEWATERHOUSECOOPERS, A SURVEY OF DISCONTINUED INSURANCE BUSINESS IN EUROPE: UNLOCKING VALUE IN RUN-OFF 8–13 (2015), <https://www.pwc.com/gx/en/insurance/assets/pdf/survey-of-discontinued-insurance-ninth-edition-report.pdf> [<https://perma.cc/C8BQ-K85H>] (listing runoff market highlights from the prior year). Leading life runoff specialists include Berkshire Hathaway Life, Swiss Re, and Wilton Re. See *id.* at 26 (noting Swiss Re's transaction activity in the life market); see also CNO Fin. Grp., Inc., *supra* note 26, at 2 (reporting a \$3.525 billion runoff transaction between Bankers Life and Casualty Company and Wilton Reassurance Company); STATE OF NEB. DEP'T OF INS., *supra* note 77, at 10–12 (noting Berkshire Hathaway Life as an affiliate of National Indemnity).

⁸⁰ See *No Slowdown in Asbestos and Environmental Claims*, BEST'S MKT. SEGMENT REP., Nov. 28, 2018, at 1, 3, 8 (reporting that “[t]he P/C insurance industry's A&E reserve has declined steadily since 2005” and noting the same in Exhibit 6).

⁸¹ See Whear & Haken, *supra* note 19, at 168.

⁸² Cf. SUBCOMM. ON OVERSIGHT & INVESTIGATIONS OF THE H. COMM. ON ENERGY & COM., 101ST CONG., FAILED PROMISES: INSURANCE COMPANY INSOLVENCIES 56–63, 67–76 (Comm. Print 1990) (reporting on the failures of the regulatory system to keep insurance companies solvent).

⁸³ See Whear & Haken, *supra* note 19, at 193–94.

This Part describes the mechanics of runoff transactions, with a focus on how the insurance runoff process transforms uncertain losses into tradable risks.⁸⁴ Section A first explains how runoff transactions are structured—most typically by insurance companies buying reinsurance for their outstanding liabilities.⁸⁵ Section B then explains at a very high level the underwriter’s transaction pricing process, the policy management process through which the liabilities are run off, and some key features of the finance and asset management functions of insurance runoff specialists.⁸⁶ With those mechanics explained, Section C turns to the runoff stories that the specialists use to explain and justify (a) the separation of the legacy liabilities—the bad bets on old insurance policies that tie up the insurer’s capital—from the active side of an insurer’s business and (b) the tough bargaining that can be a feature of running off these legacy liabilities.⁸⁷

Prior field research on the insurance business has focused on the “determinable risks” aspect of the prevailing ideal type, showing that life, disability, property, and liability insurers regularly provide insurance against uncertain risks.⁸⁸ That research has not, however, addressed the “fixed-in-advance” aspect of the ideal type, except to note that insolvency produces an (extreme) after-the-fact adjustment of what was sold as fixed-in-advance risk distribution.⁸⁹ Selling insurance for uncertain risks requires some room for such adjustments, and insurance economists’ prior research identifies some important methods, such as mutual insurance arrangements that permit post-loss assessments and organizing particularly uncertain risks into monoline insurers that are designed to go insolvent when an extreme event occurs.⁹⁰ This study reveals another, more widely applicable method for making after-the-fact adjustments that operates outside of insolvency and without post loss assessments.⁹¹

Before diving in, there are three important caveats. First, although the description that follows is drawn from insurance trade literature and other public sources whenever possible, it also draws on confidential interviews and email exchanges with participants in the runoff insurance market (actuaries, under-

⁸⁴ See *infra* notes 98–202 and accompanying text.

⁸⁵ See *infra* notes 98–116 and accompanying text.

⁸⁶ See *infra* notes 117–168 and accompanying text.

⁸⁷ See *infra* notes 169–202 and accompanying text.

⁸⁸ See, e.g., ERICSON & DOYLE, *supra* note 17 (discussing the inherent uncertainties of life and disability insurance); Baker, *supra* note 22 (noting that uncertainty is inherent in liability insurance).

⁸⁹ See, e.g., ERICSON & DOYLE, *supra* note 17, at 188–92 (discussing the potential insolvency of a British Columbia earthquake fund in the case of a major event).

⁹⁰ See Hansmann, *supra* note 5 (discussing the benefit of mutual insurance agreements for bearing industry-wide risks); Jaffee, *supra* note 33 (discussing monoline insurers’ use of insolvency to protect the market of general insurers from extreme loss).

⁹¹ See *infra* notes 98–202 and accompanying text.

writers, consultants, claims professionals, lawyers, and industry analysts) and observation in a variety of runoff-related events that I cannot describe publicly, other than to note that they included off-the-record industry workshops. Because of the small, tight network of participants in the runoff insurance market, providing more detailed descriptions of the people I interviewed or observed would reveal their identities. As with all qualitative research, this Article cannot provide conclusive evidence regarding the prevalence or extent of the practices observed, though it can help motivate and frame quantitative research that may provide that evidence.⁹² In the meantime, the persuasiveness of this qualitative study depends, like traditional doctrinal and policy arguments, on the reader's response to the reasonableness and logic of the analysis.⁹³

Second, because the insurance runoff business is so technical, any reasonably accurate explanation of the mechanics of insurance runoff may be tough going for readers without a background or strong interest in insurance finance or mergers and acquisitions. Those readers who do not have that interest or experience may want to skip ahead to the section on insurance runoff stories, which begins with a summary of what really matters about runoff mechanics.⁹⁴

Third, this Part focuses on the runoff market as it developed to manage what some in the runoff business would describe as “failures”—liabilities under legacy policies that turned out to vastly exceed what underwriters had expected.⁹⁵ Increasingly, the runoff market includes transactions in policies that did not turn out to be so unsuccessful for the underwriters, but the parties to the transactions believe, for whatever reason, that a different insurer than the one that issued them may better manage these policies.⁹⁶ Reasons include the issuing insurer's decision, perhaps in response to a change in management of

⁹² For example, quantitative research by Kathryn Zeiler et al., *Physicians' Insurance Limits and Malpractice Payments: Evidence from Texas Closed Claims, 1990–2003*, 36 J. LEGAL STUD. S9, S9 (2007), confirmed a hypothesis developed in Tom Baker, *Blood Money, New Money, and the Moral Economy of Tort Law in Action*, 35 LAW & SOC'Y REV. 275, 314 (2001), and quantitative research by Catherine M. Sharkey & Jonathan Klick, *The Fungibility of Damage Awards: Punitive Damage Caps and Substitution* 19–20 (Columbia L. Sch., Law & Econ. Rsch. Paper Series, Working Paper No. 298, 2007), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=912256 [<https://perma.cc/SNW8-MWW7>], confirmed a hypothesis developed in Tom Baker, *Transforming Punishment into Compensation: In the Shadow of Punitive Damages*, 1998 WIS. L. REV. 211, 234–35, and quantitative research by Blakeley B. McShane et al., *Predicting Securities Fraud Settlements and Amounts: A Hierarchical Bayesian Model of Federal Securities Class Action Lawsuits*, 9 J. EMPIRICAL LEGAL STUD. 482, 485, 502, 508 (2012), confirmed hypotheses developed in Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 831–32 (2009).

⁹³ Baker & Griffith, *supra* note 21, at 492.

⁹⁴ See *infra* Part III.C.

⁹⁵ Charles Ehrlich, *Why Are We Here?*, AIRROC MATTERS, Summer 2015, at 20, 20.

⁹⁶ See E-mail from anonymous runoff market participant to author (June 24, 2019) (on file with author).

the insurance company or the legal or regulatory environment, to focus its business in one region rather than another, one type of insurance rather than another, or one category of customer rather than another.⁹⁷ I focus in this Article on the runoff of the failures because those transactions best demonstrate the resilience of insurance markets and the mechanism for transforming uncertainty into tradable risk.

A. Insurance Runoff Transaction Structure

The starting point for understanding the structure of insurance runoff transactions is the legal rule that one insurer may not assign an insurance policy to another insurer (or anyone else) without the consent of the policyholder (absent a difficult-to-achieve regulatory approval that is not available in most United States jurisdictions).⁹⁸ Nevertheless, one insurer may contract with another insurer to fulfill the first insurer's obligations under an insurance policy, but the obligation to perform remains that of the first insurer, unless the policyholder consents to transfer that obligation to the second insurer.⁹⁹ If the second insurer fails to perform, the policyholder sues the first insurer, not the second (assuming, as is almost always the case in the property casualty insurance context, that the policyholder did not consent to the transfer).¹⁰⁰ This insurance law rule contrasts with the legal rule governing credit contracts, which are freely assignable.¹⁰¹

Because policyholder consent to transfer is difficult to obtain, especially at scale, an insurance group in the property casualty sector in the United States

⁹⁷ *Id.*

⁹⁸ See Nick Pearson, *Shedding Liabilities*, AIRROC MATTERS, Spring 2010, at 1, 1 (noting that the only way for an insurer to legally eliminate liabilities is through assumption reinsurance). Countries in Europe typically permit the outright sale of books of insurance policies, subject to regulatory approval. See generally INT'L BAR ASS'N INS. COMM., INSURANCE PORTFOLIO TRANSFERS: "MOVE ON AND LET GO" (2010), <https://www.ibanet.org/Document/Default.aspx?DocumentId=CC04FD0A-63F5-42C1-B0AA-8CB11FAA6B62> [<https://perma.cc/8YNB-C4RK>] (surveying jurisdictional practices regarding insurance portfolio transfers); SIDLEY AUSTIN LLP, PART VII TRANSFERS EFFECTED PURSUANT TO THE UK FINANCIAL SERVICES AND MARKETS ACT 2000 (2020), <https://www.sidley.com/-/media/publications/part-vii-transfers.pdf> [<https://perma.cc/TSJ8-E3DD>] (listing UK insurance business transfers). There is effort underway to make such transactions permissible in the United States. See Matthew Gendron, *Rhode Island's Voluntary Restructuring of Solvent Insurers Law and Similar Efforts in Other States*, 23 ROGER WILLIAMS U. L. REV. 470, 474–75 (2018) (discussing that Rhode Island law and regulation, based on European systems, now allow books of business to be contractually transferred to Rhode Island domestic insurers). Analysis of the merits of that legislation is outside the scope of this Article.

⁹⁹ See Pearson, *supra* note 98, at 1, 7.

¹⁰⁰ See *id.* (highlighting that legal separation requires policyholder consent and noting that the difficulty of the consent requirement has acted as a disincentive for full separation).

¹⁰¹ See, e.g., MICHAEL S. BARR ET AL., FINANCIAL REGULATION: LAW AND POLICY 183–94 (2d ed. 2018).

can terminate its obligations under a set of insurance policies as a practical matter only if: (a) it sold the policies through a separately incorporated subsidiary that it now can sell to another insurance group, or (b) it can divide the entity that sold the policies into two or more legally separate parts and sell the part of that entity that holds the policies in question.¹⁰² The latter option is not available in most U.S. states, and, because of the regulatory scrutiny required, it is not widely used in those jurisdictions in which it is available (for example, Pennsylvania).¹⁰³ In contrast, when there is a separately incorporated entity, the contractual relationship is between the policyholders and that entity, not the corporate group under whose brand the entity operated. Thus, the entity can be sold without violating the insurance law rule against assigning insurance policies. Once the regulatory authority with jurisdiction over the entity approves the sale, it gives the buyer complete control over that entity, subject only to compliance with legal requirements, and it gives the seller a “clean exit” from the liabilities of that entity.¹⁰⁴

Life and health insurers have greater opportunity to transfer a set of policies from one company to another, using a transaction known as “assumption reinsurance” (a confusing term for what amounts to the sale of a block of policies with the “consent”—sometimes constructive—of each policyholder).¹⁰⁵ Typically, policyholders in the life insurance sector have an ongoing obligation to pay premiums and, thus, an ongoing relationship with their insurance company. After the sale of the assumption reinsurance to the insurer that issued the policies, the assuming reinsurer (in substance, the purchaser of the block of policies) obtains consent from the policyholders to the transfer of the policies to the reinsurer through the process of collecting premiums on renewal or, in

¹⁰² See Carter et al., *supra* note 19, at 224–34 (noting both that this simple task of obtaining consent turns into difficult work and the process for dividing and selling a piece of an insurance entity available in the UK).

¹⁰³ See *id.* at 224–27, 235 (discussing the existence of this option in the UK and Rhode Island); Gendron, *supra* note 98, at 493–94 (noting such laws exist in Connecticut, Pennsylvania, and Arizona, but that they necessitate the division meet strict requirements); see, e.g., Affidavit of Professor Tom Baker, *supra* note 26, at 47–55 (discussing CIGNA’s separation into subsidiaries in accordance with Pennsylvania law, noting the higher bars of regulatory scrutiny, and remarking that New York does not have the same statute).

¹⁰⁴ *Market Issues and Why to Sell*, CATALINA, <https://www.catalinare.com/market-issues-and-why-to-sell/> [<https://perma.cc/8L7K-FP57>] (“Selling legacy liabilities gives a clean exit to an existing risk for the seller . . .”). Note that there may remain some uncertainty about whether all future courts will honor the legal distinction between the subsidiary that issued the insurance and the parent that later sold the subsidiary. See *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439–40 (Del. 1971) (holding that equitable principles apply to corporate actions).

¹⁰⁵ See JOHN E. TILLER, JR. & DENISE FAGERBERG TILLER, *LIFE, HEALTH & ANNUITY REINSURANCE* 435–43 (4th ed. 2015) (explaining the accounting effects of an assumption reinsurance transaction). A cynic might conclude that the practitioners refer to the transaction as “reinsurance” to obscure the fact that the transaction terminates the original insurer’s legal obligation.

some states, through a special notice procedure in which policyholders are deemed to consent if they do not object.¹⁰⁶

All other runoff market transactions involving policies issued in the United States must use reinsurance transactions that are similar in important ways to the reinsurance-to-close used at Lloyd's.¹⁰⁷ This reinsurance does not terminate the insurer's obligations under the policies that are the subject of the transaction.¹⁰⁸ At most, it provides the insurer with financial protection from its liabilities under those policies, and the degree of that protection varies considerably depending on the terms of the deal.¹⁰⁹

The most common form of reinsurance-based runoff market transaction in the property casualty sector is called a "loss portfolio transfer" (LPT).¹¹⁰ An LPT has two main parts: (a) a retroactive reinsurance contract in which the original insurer pays a large premium in return for the runoff specialist's agreement to pay claims under a designated set of legacy insurance policies, up to a total dollar amount known as the reinsurance "limit"; and (b) a management contract in which the runoff specialist agrees to manage these policies on the original insurer's behalf, unless and until the losses incurred under the policies exceed the reinsurance limit.¹¹¹ If the losses paid under those policies exceed that reinsurance limit, the responsibility for paying claims and otherwise managing the legacy policies reverts to the original insurer, as has occurred in

¹⁰⁶ *Id.* at 160–73. Tiller and Fagerberg Tiller note that the legal rules regarding assumption reinsurance are sufficiently uncertain, the prospect that at least some policyholders will object are sufficiently likely, and that assumption reinsurance transactions typically are structured in the alternative as indemnity coinsurance transactions. *Id.* As a result, the practical differences between the runoff transaction structures that are possible in the life insurance sector and in the property casualty sector are less than would appear in theory. *See id.*

¹⁰⁷ *See supra* notes 42–45 and accompanying text (describing the reinsurance-to-close transaction).

¹⁰⁸ *See* Pearson, *supra* note 98, at 1.

¹⁰⁹ *See* Carter et al., *supra* note 19, at 222–23 (describing that regular reinsurance provides you some protection from liabilities but does not truly allow full separation because reinsurers will almost always negotiate reinsurance limits).

¹¹⁰ NAT'L ASS'N INS. COMM'RS, STATUTORY ISSUE PAPER NO. 137: TRANSFER OF PROPERTY AND CASUALTY REINSURANCE AGREEMENTS IN RUN-OFF 137-1 to -2, -19 (2009), https://content.naic.org/sites/default/files/inline-files/137_b.pdf [<https://perma.cc/5442-5T7P>] (addressing the accounting treatment of "reinsurance run-off agreements," which is another term for an LPT reinsurance agreement, and noting that such agreements often "must be approved by the domiciliary regulators of the transferring entity"); Neil Bruce et al., *Loss Portfolio Transfers* (Inst. & Fac. Actuaries, 2002 Giro Working Party Paper, 2002, actuaries.org.uk/system/files/documents/pdf/Macnair_0.pdf [<https://perma.cc/A2GS-PT2L>] (analyzing LPT arrangements for the General Insurance Research Organization of the Institute and Faculty of Actuaries in the UK); Derek A. Jones, *An Introduction to Reserving and Financial Reporting Issues for Non-Traditional Reinsurance*, CAS. ACTUARIAL SOC'Y F., Fall 2004, at 73, 76, <http://www.casact.org/pubs/forum/04fforum/> [<https://web.archive.org/web/20201008175737/http://www.casact.org/pubs/forum/04fforum/>] (discussing LPTs as one of the "most common retroactive reinsurance arrangements").

¹¹¹ *See* Bruce et al., *supra* note 110, §§ 5–6; Jones, *supra* note 110, at 76–81.

the case of a transaction involving Berkshire Hathaway's NICO and the oldest continuously operating property casualty company in the United States, the Insurance Company of North America, later known as "INA" and now owned as the Chubb insurance group.¹¹² This residual liability distinguishes an LPT from the "insurance portfolio transfer" permitted in Europe (under close regulatory supervision), in which the transaction terminates the original insurer's legal obligations.¹¹³

Because an LPT does not legally separate the runoff book from the rest of the original insurer's assets and liabilities, this form of insurance runoff transaction leaves the original insurer exposed to two kinds of risk that are not present when an insurance group sells a legally separate entity: (a) counterparty credit risk (the risk that the reinsurer will go insolvent); and (b) the risk that the total liabilities will exceed the limit of reinsurance. The original insurer can mitigate the latter risk by also purchasing another form of reinsurance, known as "adverse development cover," that provides additional reinsurance if the loss portfolio transfer reinsurance limit is exhausted.¹¹⁴ Of course, that adverse development cover is subject to its own credit risk and the risk that its limit will also be exhausted.

The equivalent transaction in the life sector is called "indemnity coinsurance."¹¹⁵ Key differences between a typical indemnity coinsurance transaction and a typical LPT transaction include the following: (a) indemnity coinsurance often leaves the original insurer with an identified share of the risk, twenty percent being typical; (b) indemnity coinsurance rarely sets a limit on the reinsur-

¹¹² See Sallie B. Kraus, *Looking Back and Forward on Asbestos Claims*, 27 ENV'T CLAIMS J. 149, 151 n.8 (2015) (reporting that the NICO-Brandywine agreement was exhausted on an incurred basis in 2002 and on a paid basis in 2013); see also Bruce et al., *supra* note 110, § 6.12 (discussing the mechanics and effects of limits).

¹¹³ See generally INT'L BAR ASS'N INS. COMM., *supra* note 98 (surveying jurisdictional practices regarding insurance portfolio transfers). There is a movement to permit similar transactions in the United States. See Gendron, *supra* note 98, at 474–75, 493–92 (noting laws that reflect this European system have been adopted in Rhode Island, Connecticut, Pennsylvania, and Arizona).

¹¹⁴ See Eleni Iacovides, *The Legacy Market*, AIRROC MATTERS, Fall 2017, at 20–21, 23. Note that property casualty insurers also can purchase adverse development cover instead of an LPT. In that case, the insurer retains day to day responsibility for the runoff, and the adverse development cover simply provides protection (up to the limit of the cover) from liabilities that exceed the insurer's reserves. See Jones, *supra* note 110, at 76–77 (noting that an adverse development cover can protect loss reserves from corrosion).

¹¹⁵ For a description of indemnity coinsurance, see Jeremy Starr, *Use of Reinsurance in Mergers and Acquisitions* 1, 1–6, 12, 15 (Rec. Proc. Soc'y Actuaries, Minutes of May 24–25, 1999 Meeting, 2000), <https://www.soa.org/globalassets/assets/library/proceedings/record-of-the-society-of-actuaries/1990-99/1999/january/rsa99v25n171pd.pdf> [<https://perma.cc/24TZ-KU5K>] (explaining a coinsurance transaction and noting their prevalence); Maryann Taylor, *The Life Deal Market*, AIRROC MATTERS, Winter 2018–2019, at 29, 29 (noting that indemnity coinsurance is the most common form of life runoff transaction). For a description of the various forms of reinsurance-based life runoff structures, see TILLER & FAGERBERG TILLER, *supra* note 105, at 175–92.

ance company's exposure for its share of the reinsured risk; and (c) the original insurer more often retains the responsibility for administering the policies.¹¹⁶

B. Key Activities of an Insurance Runoff Enterprise

In whatever way a runoff specialist acquires the runoff liabilities—by buying entities, through an LPT or insurance portfolio transfer, or through the life insurance equivalents—the specialist's core business consists of four activities that are part of any insurance enterprise but have special features in the runoff context: underwriting, policy management, asset management, and finance. The three subsections that follow provide a basic description of these activities in the context of runoff specialists and their role in making uncertainty tradable.

1. Underwriting

Underwriting is the process of deciding whether to offer (re)insurance and, if so, at what price. Underwriting the runoff of a book of insurance policies differs from underwriting the initial sale or prospective reinsurance of insurance policies in both the nature of the information on which the transaction is based and the scale of the transaction. A runoff transaction represents a wholesale repricing of an entire book of legacy business with the benefit of hindsight—meaning, all the information about the liabilities covered by the policies learned in the years since the policies initially were sold.¹¹⁷

The runoff underwriting process consists of estimating inputs to a valuation formula:

- (1) a projection of cash outflows for the book of policies;
- (2) a projection of offsetting cash inflows from any reinsurance that the insurer previously purchased to support that book and, in the case of life and health products, cash inflows from any premiums and contributions that will be made for the policies while they are being run off;

¹¹⁶ Interview with anonymous runoff market participant in N.Y.C., N.Y. (May 16, 2019) (on file with author). Indemnity coinsurance in which the ceding insurer retains the administrative responsibility is more like what is called adverse development cover in the property casualty context, with the key difference being the way that the risk is shared. *Compare id.* (describing the mechanics of indemnity coinsurance), with *supra* note 114 and accompanying text (describing adverse development cover). Indemnity coinsurance is a quota share transaction, with the reinsurer taking one hundred percent of the designated share; adverse development cover is an excess of loss transaction with a cap that leaves the extreme right tail risk with the ceding insurer. Interview with anonymous runoff market participant, *supra*.

¹¹⁷ See Frederick J. Pomerantz et al., *Rx for Run Off: Four Experts Expound*, AIRROC MATTERS, Summer 2015, at 6, 7 (noting that a principal part of evaluating runoff claims is reviewing past files, payout patterns, and claim disputes).

- (3) an evaluation of the adequacy of the reserves that the insurer has posted on the liability side of its balance sheet for the book of policies and the value of the assets it lists on the asset side of its balance sheet to offset those reserves; and
- (4) a projection of investment returns from the assets that the runoff specialist plans to hold to offset the reserves that it will carry on its balance sheet for the reinsurance.¹¹⁸

Because the original insurer has been managing the book for years, as have other insurers who sold similar policies covering similar losses in the past, the quality of the information available to estimate the potential losses and offsetting cash flows is greater than when the underlying policies were sold.¹¹⁹ In addition, the passage of time means that investment returns need to be projected less far into the future.¹²⁰ This hindsight is a key part of what transforms the uncertainties of yesterday into the tradable risks of today.

With these inputs, a runoff specialist can provide a quote for the runoff transaction.¹²¹ For the sale of a separately incorporated entity, the quote is simply a price for the purchase of that entity. Whereas usually the prices we pay for the things we buy are positive numbers, the same is not true in the runoff market. If the entity is poorly reserved, the price may be a negative number. That negative number will be, in effect, a “dowry” of capital that the parent of the entity (typically a holding company in the insurance group) will have to put into the entity before the specialist will be willing to buy it for a nominal price.¹²²

¹¹⁸ See *id.* at 7, 9 (describing important aspects of runoff underwriting and observing, “[b]asically when you look at value it’s just a time value of money equation. So there’s really two things that matter on the income side: premiums and investment income and on the liability side it’s payments and timing of those payments”). Note that when underwriting a “buy to kill” transaction, the acquirer also needs to assess the value of any renewal rights that it plans to sell before putting the company into runoff. See *id.* at 12 (discussing “buy to kill” strategies).

¹¹⁹ See *id.* at 7, 9.

¹²⁰ See Bruce et al., *supra* note 110, § 8 (mentioning that the premium must evaluate among other things future investment returns); Pomerantz et al., *supra* note 117, at 7, 9 (stressing the importance of time and historical data in runoff underwriting).

¹²¹ See Pomerantz et al., *supra* note 117, at 9.

¹²² See Bruce et al., *supra* note 110, § 7.8 (noting that the present value of an evaluation can be negative). Because life insurance reserves can be discounted to present value, and property and casualty insurance reserves cannot, property casualty insurance companies are less likely to be under-reserved for legacy liabilities than life insurance companies. Compare NAT’L ASS’N INS. COMM’RS, STATEMENT OF STATUTORY ACCOUNTING PRINCIPLES NO. 51: LIFE CONTRACTS ¶ 15 (1998) (“These statutory [life insurance] policy reserves are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums.”), with NAT’L ASS’N INS. COMM’RS, STATEMENT OF STATUTORY ACCOUNTING PRINCIPLES NO. 55: UNPAID CLAIMS, LOSSES AND LOSS ADJUSTMENT EXPENSES ¶ 10 (1998) (“These [property and casualty] liabilities shall not be discounted unless authorized for specific types of claims . . .”).

For a reinsurance-based transaction, the quote will consist of two key numbers: (a) the reinsurance limit, which is the maximum amount that the runoff acquirer is obligated to pay out on the book over the course of the runoff, after which responsibility for managing the runoff reverts to the original insurer (this number can include policy management expenses or not, depending on the deal); and (b) the additional premium that the underwriter will charge, if any, on top of taking all the assets that presently support the liabilities that the insurer has set as the reserves for the book.¹²³ The higher the total limit of the reinsurance that the runoff underwriter offers (or the ceding insurer demands), the higher the premium will be (all other things being equal), with the premium to be still higher if the underwriter agrees to assume the issuing insurer's liabilities for the book without limit (in which case the transaction would be equivalent to the reinsurance-to-close transactions used at Lloyd's).¹²⁴ Similarly, the more adequately reserved the underwriter judges the book of policies to be, the lower the premium charged on top of those assets will be.¹²⁵ A poorly reserved insurer might still be able to do a loss portfolio transfer without paying any premium beyond the transfer of the assets currently offsetting the reserves for the book, but the reinsurance limit would almost certainly be too low to provide the insurer with much confidence that the liabilities were gone for good.

2. Policy Management

The runoff underwriting process can be understood as a technical exercise that reflects the increasingly predictable and therefore tradable nature of past uncertainties that ordinarily occurs with the simple passage of time. This understanding would be too simplistic, among other reasons because no liabilities are tradable until there is a buyer prepared to treat them as such, but it is not entirely wrong. By contrast, it would be entirely wrong to understand runoff policy management in similarly passive terms. Runoff policy management ac-

This means that life insurance runoff transactions are more likely to require a dowry than property and casualty insurance runoff transactions. Email from anonymous run-off market participant to author (Nov. 24, 2020) (on file with author). The key accounting difference concerns the ability to discount future payments to present value. *See id.* Unlike life insurance accounting, property casualty insurance accounting typically does not permit such discounting when setting reserves for future liabilities and, thus, property casualty companies are less likely to be under reserved, at least on a present value basis. *See* NAT'L ASS'N INS. COMM'RS, STATEMENT OF STATUTORY ACCOUNTING PRINCIPLES NO. 55, *supra*.

¹²³ *See* Jones, *supra* note 110, at 79–82 (noting common features in reinsurance deals including aggregate limits and additional premiums to be paid depending on loss history).

¹²⁴ *See supra* note 118 and accompanying text (noting the high-level algebraic model for calculating reinsurance premiums); *supra* notes 42–45 and accompanying text (describing the reinsurance-to-close transactions of Lloyd's).

¹²⁵ *See supra* note 118 and accompanying text (noting the high-level algebraic model for calculating reinsurance premiums).

tively shapes the activities that produce the cash flows that determine whether the predictions underlying runoff transactions come to pass.

The day-to-day activity of running off insurance policies differs according to the type of insurance policies involved. For liability and property insurance runoffs, policy management means handling and paying claims, computing and collecting any retrospective premiums,¹²⁶ recovering any owed reinsurance, and, importantly, negotiating commutations.¹²⁷ A “commutation” is a modification of a (re)insurance contract in which the (re)insurer agrees to pay the policyholder/insurer a sum certain in return for the policyholder/insurer agreeing that this sum certain satisfies all of the (re)insurer’s obligations under the policy.¹²⁸ A commutation is a “buy back” of the policy from the perspective of the (re)insurer and a “sell back” of the policy from the perspective of the (re)insured.¹²⁹

Commutations are an important part of the runoff policy management story for two reasons. First, commutations provide the best evidence that runoff policy management differs from active policy management. Although commutations sometimes take place in an active insurance business, for example, to resolve a dispute over a large commercial insurance claim,¹³⁰ the aggressive pursuit of commutations is not part of the ordinary strategy of an active insur-

¹²⁶ A retrospective premium is an additional premium paid on an ex post basis, when claim payments exceed negotiated amounts.

¹²⁷ Michael T. Walsh & Maryann Taylor, *Commutations: A Road to Finality*, AIRROC MATTERS, Summer 2007, at 1, 1 (“Commutations are indeed one of the most vital tools to the strategic plans of run-off operations.”).

¹²⁸ See Charles J. Widder, *Commutation of Reinsurance Agreements: A Business Decision Based on Economics and Risk Appetite: A Collaborative and Negotiable Process*, AIRROC MATTERS, Summer 2007, at 10, 10. For a hypothetical example of a commutation, consider the following. Trustworthy Insurance Company (Trustworthy) insures Asbestos Manufacturer. Trustworthy agrees to pay the \$2 million limits of its policy to fund the defense costs and settlements of a group of asbestos claims against Manufacturer. Trustworthy demands that Great Reinsurance Company (Great) pay \$5 million of that amount, under a treaty that promised to pay 25% of Trustworthy’s 1985 accident year general liability losses (above a \$10 million level that was long ago reached), subject to a reinsurance treaty limit of \$50 million (of which \$40 million has been paid). Great recently was sold to a runoff specialist. Great’s new claims manager tells Trustworthy that it has conducted a thorough review of Great’s pre-1990 treaties and determined that Great has been paying claims to Trustworthy and others that it was not legally obligated to pay. Great offers to pay \$5.5 million today to commute the treaty, meaning that Trustworthy would be unable to collect any money under the treaty in the future and that Great would be unable to reopen any prior payments.

¹²⁹ See Carter et al., *supra* note 19 (“A commutation is in effect, an underwriting exercise where the reinsured is paid to take back risk that it had laid off.”); Whear & Haken, *supra* note 19, at 168–69 (referring to commutations buy-backs).

¹³⁰ See E-mail from anonymous runoff market participant to author (Nov. 11, 2020) (on file with author). For example, a senior policyholder coverage lawyer explained to me that several asbestos or environmental defendants have commuted some or all their historical general liability insurance policies to resolve coverage litigation with their insurers. *Id.*

ance business.¹³¹ By contrast, property casualty runoff specialists advertise their skill and experience with commutations, and their United States trade association actively facilitates commutations.¹³²

Second, commutations can play a key role in transforming uncertainty into tradable risk. At the transaction level, a commutation transfers any remaining uncertainty regarding the losses that would have been covered by the (re)insurance contract back to the counterparty who accepted a payment in satisfaction of that contract.¹³³ At the market level, the availability of commutations makes runoff specialists more willing to do runoff deals, because they know that they can use commutations—“the chosen weapon of many in the legacy sector to assist in their quest to find the Holy Grail of ‘finality’ to their liabilities”—to reduce the uncertainty involved in runoff transactions.¹³⁴

At a very high level, property casualty runoff specialists follow two approaches to managing the runoff after the acquisition: “slow” and “accelerated.” A slow runoff manages the policies in much the same way that an active insurance company manages its obligations under old policies that remain part of the insurer’s active business: paying claims as they come due and collecting on any reinsurance for those claims on the same timetable, perhaps with less urgency and greater attention to coverage defenses than would be the case if the insurer was interested in selling new policies to existing customers.¹³⁵ This

¹³¹ See Walsh & Taylor, *supra* note 127 (noting the commutation’s vital importance in runoff operations).

¹³² See, e.g., ENSTAR GRP., ENSTAR ANNUAL REPORT 2017, at 6–7 (2018) (discussing how commutations are conducted as a part of Enstar’s runoff management process); AIRROC’s *Mission and Vision*, AIRROC, <https://www.airroc.org/mission-statement> [<https://perma.cc/7PUN-YMMZ>] (articulating that “AIRROC’s VISION is to be the most valued (re)insurance industry educator and network provider for issue resolution and creation of optimal exit strategies”).

¹³³ See Whear & Haken, *supra* note 19, at 168–69 (describing the basic operation of commutations).

¹³⁴ Julius Bannister, *Bygone Companies: Bannister’s Ballywick*, AIRROC MATTERS, Summer 2015, at 15, 15–16 (providing a summary of “a major listing of commutations”).

¹³⁵ See AIRROC Roundtable Discussion—March 5, 2008, AIRROC MATTERS, Spring 2008, at 18, 19 (“In other situations the goal of the run-off operation is to delay the payment of claims.”). I describe below the critique that slow runoffs are much slower than ordinary. See *infra* notes 191–197 and accompanying text (discussing critiques); cf. JAY M. FEINMAN, DELAY, DENY, DEFEND: WHY INSURANCE COMPANIES DON’T PAY CLAIMS AND WHAT YOU CAN DO ABOUT IT 5–8 (2010) (suggesting that difficulties in the claims process are not unique to the runoff market). One insurance industry insider made this observation:

There are only two ways to make money in runoff: earning more returns on assets and paying less on claims, pennies on the dollar. Look at Berkshire’s investments. I’m not saying that they do this, but they could drag out claims, keep them tied up in litigation, to the point where people would accept pennies on the dollar.

Interview with anonymous runoff market participant in Phila., Pa. (Mar. 1, 2019) (on file with author).

kind of runoff is slow because it takes a long time for all the obligations under the policies to mature and be satisfied in the ordinary course.

An accelerated runoff speeds up the process by reaching out to the original insurer's counter parties and offering to commute their legacy insurance policies and reinsurance contracts.¹³⁶ Because commutations are voluntary on both ends, negotiating commutations is a core expertise of an accelerated runoff specialist.¹³⁷ It is my impression that accelerated runoffs generally take place in the runoff of a reinsurance company. That makes sense because the counterparties to reinsurance commutations are insurance companies. Reinsurance contracts tend to involve enough money to make the commutation process worth doing, and insurance companies have become increasingly comfortable with commuting their reinsurance. Although the commutation indisputably shifts some risk back to the insurer, that risk is just more of the same risk that the insurer already faces, and, thus, already has on its balance sheet.¹³⁸ Often, the runoff specialist can offer reinsurance commutation terms that improve the balance sheets of the insurance company counterparties.¹³⁹ The exception is when the reinsurer being run off is in weak financial condition. In that circumstance, however, insurance company counterparties should be even more willing to commute their reinsurance contracts, because of the risk that they will later recover even less if the reinsurer becomes more financially impaired.¹⁴⁰ As the latter point suggests, runoff specialists are adept at turning financial weakness into a negotiating strength.¹⁴¹

¹³⁶ See *AIRROC Roundtable Discussion—March 5, 2008*, *supra* note 135, at 19 (“[T]here are many run-off entities . . . that are looking for a resolution of all of their claims in a short period of time.”).

¹³⁷ See Terry Kelaher, *Claim Estimation*, *AIRROC MATTERS*, Fall 2005, at 16, 16 (contrasting the voluntary nature of commutation from “forced non-contractual estimation and payment acceleration”). For a time, the UK permitted the involuntary, wholesale commutation of policies and reinsurance contracts through a process that was known as a “solvent scheme of arrangement.” See Gendron, *supra* note 98, at 480–84 (discussing this practice in the UK). That process has for all practical purposes been shut down by the British courts and the Prudential Regulatory Authority. See, e.g., *In re Brit. Aviation Ins. Co.* [2005] EWHC (Ch) 1621, [143] (UK) (denying a scheme because it is unfair to require policyholders to have their risk unilaterally resented to them).

¹³⁸ See Interview with anonymous runoff market participant in Hartford, Conn. (Apr. 7, 2019) (explaining that “solvent runoff socializes losses among the insurance industry according to each insurer’s exposure to the runoff entity”).

¹³⁹ See Widder, *supra* note 128, at 10, 12 (“The ceding entity, may in fact, have concluded that the reinsurance provided is no longer necessary and prefers to assume the liabilities back from the reinsurer along with a cash payment.”).

¹⁴⁰ See *id.* at 11–12 (discussing the negotiation process and how one party’s financial strength or weakness should not derail a negotiation).

¹⁴¹ See Susanne Sclafane, *Adverse Development Covers on the Rise*, *NAT’L UNDERWRITER*, July 24, 2000, at S-11, S-23 (“Not only does a reinsurer need a great deal of manpower and runoff expertise to take ownership, but ‘you need to be structured in a way that you don’t mind squeezing cedent clients,’ he [PXRE’s Jeffrey Mayer] said. Profitably running off claims might mean offering [twenty]

The greater importance of commutations in reinsurance runoff signifies another important difference between the runoff of insurance and reinsurance liabilities. Because reinsurers' counterparties are insurance companies, any haircuts, delays, compromises or other variations from "normal" reinsurance market practice that are part of runoff have the effect of socializing losses among the broader insurance industry that originally issued the policies, similar in some ways to how Equitas socialized losses among the Names of the open syndicates.¹⁴² Especially because runoff market transactions frequently involve loss categories that the entire market underestimated, reinsurance runoff can be understood as a process for sharing uncertainty across the broader insurance pool, based on the relative exposure of (re)insurers to the liabilities being run off.¹⁴³ This process may not be as explicit or predictable as the market-share based assessments that fund the insurance guaranty funds that step in to pay claims when insurers become insolvent, but it is similar in kind.

Retail insurance runoff is very different in this regard. Any haircuts, delays, compromises or other variations from "normal" retail market practice that are part of runoff have the effect of de-socializing losses, by leaving a greater share of those losses with the people or organizations that purchased the insurance.¹⁴⁴ This difference helps explain the much greater regulatory scrutiny given to the runoff of retail insurance operations than to reinsurance.¹⁴⁵

The life insurance runoff market grew somewhat later and in response to different developments than property casualty runoff. In life insurance, the problems that lead to runoff are more likely to come from the asset side of the balance sheet: returns on investments that turn out to be much lower than ex-

cents on the dollar, he said, suggesting that for a reinsurer to make runoff operations successful it needs to segregate its "bad cop" runoff experts from the remaining "good cops."").

¹⁴² See *supra* note 65 and accompanying text (discussing how Equitas acted to broadly socialize the losses of Lloyd's pre-1993 liabilities).

¹⁴³ On runoff companies acquiring underestimated loss categories, see, for example, NAIC LLOYD'S REPORT, *supra* note 24, at 9 (noting how the restructuring of Lloyd's included the transfer of APH liabilities, particularly those related to asbestos); PRICEWATERHOUSECOOPERS, *supra* note 79, at 22 (noting that challenges in meeting guaranteed returns on the back books of insurers life insurance policies would result in further sales of these guaranteed return life policies to runoff companies); *Solutions*, RIVERSTONE, <https://www.trg.com/what-we-do/> [<https://perma.cc/JK7W-V8WC>] (describing how Riverstone acquires policies in runoff covering asbestos, pollution, and health hazards (APH), as well as workers' compensation); compare Randi Elias, *Construction Defect Claims: Coverages and Cases*, AIRROC MATTERS, Winter 2015, at 26, 26 (describing a runoff industry presentation addressing various issues related to construction defect claims, another loss category relevant to the interests of runoff insurance companies).

¹⁴⁴ *Contra supra* notes 142–143 and accompanying text (discussing how reinsurance commutations may socialize losses within the industry).

¹⁴⁵ Interview with anonymous runoff market participant in Phila., Pa. (May 8, 2019) (on file with author).

pected.¹⁴⁶ Life insurance industry runoffs typically involve savings-linked insurance products that were priced based on overly optimistic assumptions about interest rates, which would of course affect what the company would be able to earn from the assets under investment: whole life insurance, annuities, pension guarantees, and long-term-care insurance.¹⁴⁷ Among these, long-term-care insurance runoffs are unique in that they involve not only unrealistic assumptions about earnings from assets, but also problems on the liability side of the balance sheet: changes in the costs of, and demand for, long-term care.¹⁴⁸

For all these life insurance product runoffs, policy management includes collecting premiums and contributions from policyholders whose policies remain in force, communicating with those policyholders, and engaging in related customer service activities, in addition to collecting reinsurance and handling and paying claims. Thus, life insurance runoff also differs from property casualty runoff in the ongoing relationship between the insurance company and its policyholders.¹⁴⁹ In a property casualty insurance runoff, there are no premiums to be collected or policies to be renewed; the only ongoing relationship revolves around claims. The ongoing relationship in the life insurance segment

¹⁴⁶ See, e.g., Leslie Scism, *Hartford to Sell 'Run-off' Life Insurance Business*, MARKETWATCH (Dec. 4, 2017), <https://www.marketwatch.com/story/hartford-to-sell-run-off-life-insurance-business-2017-12-04> [<https://perma.cc/84MR-FUHJ>] (pointing out that the 2008 market downturn and its aftermath led to this transaction).

¹⁴⁷ See, e.g., *id.* (noting that a savings-based annuity product was at the heart of the downturn of the business).

¹⁴⁸ See, e.g., Jalayne J. Arias, *The Last Hope: How Starting Over Could Save Private Long-Term Care Insurance*, 29 HEALTH MATRIX 127, 148–50 (2019) (discussing market failures of these long-term-care insurance products).

¹⁴⁹ Swiss Re described its life runoff business in a 2019 prospectus as follows:

We acquire portfolios through acquisition of entire lines of business (and a subsequent transfer of the business to us in the United Kingdom under Part VII of FSMA or the entire share capital of (or a majority stake in) life insurance companies, or through reinsurance. We typically assume responsibility for administering the underlying policies in such portfolios until they reach maturity, are surrendered or an insured event occurs resulting in the termination of the policies. In addition, we write a nominal amount of new business on a passive basis normally for existing customers that request “top-ups” of current contracts or who need to move to an alternative product type to access certain product features. Our strategy is centered around gross cash generation (excess capital available compared with the target capital position) and we seek to maximize our future expected profits through a combination of efficient management of existing policies, disciplined asset management, the acquisition of additional books of business and consolidation of new business with existing operations to benefit from capital and asset management, operational and incidental tax synergies.

SWISS RE, SWISS RE GLOBAL SHARE PARTICIPATION PLAN 2019 PROSPECTUS 64 (2019), https://www.swissre.com/dam/jcr:51c80e34-c8ab-46c2-b69c-6cd8c1ef9dcd/Swiss_Re_GSPP_Prospectus.pdf [<https://perma.cc/3BVD-7QCY>].

makes it difficult to commute policies.¹⁵⁰ Thus, life insurance runoff investors tend to be companies that have a long-term asset management focus.¹⁵¹

As even this very general description makes plain, runoff policy management details differ greatly across insurance market segments, with each segment posing a different set of uncertainties to manage. Asbestos liabilities are similar in many, but not all, ways to environmental liabilities; both kinds of toxic tort liabilities differ significantly from medical malpractice, workers compensation, and municipal liabilities; these liabilities differ from sexual abuse and molestation claims; and natural catastrophe and mega property insurance claims differ significantly from liability insurance claims. On the life and health insurance side of the insurance business, life insurance presents policy management challenges that are similar to, but significantly different from, annuities and pensions; and long-term-care insurance presents its own distinct set of challenges.

Because of these differences among insurance market segments, the details of insurance runoff policy management resist easy generalization. The common thread that runs throughout runoff policy management is that intensive exposure to the legacy liabilities of each particular market segment leads to expertise and relationships that have the potential to reduce the costs of running off those liabilities.¹⁵² Through this exposure, the runoff specialists identi-

¹⁵⁰ There are two kinds of life transactions that have a similar impact as a commutation: (1) companies managing an annuity runoff sometimes offer policyholders an “enhanced annuitization” option, that amounts to a buyout of the annuity, Interview with anonymous market participant in N.Y.C., N.Y., *supra* note 116, and (2) when companies managing a long-term-care runoff receive regulatory approval to increase rates for in force policies, they typically offer policyholders the option of selecting a shorter benefit period, and that has the effect of reducing the right tail risk of the company, *id.* An improper practice that would significantly limit the right tail risk of the runoff operation is inducing policyholders to lapse. See Jean Pinquet et al., *Commitment and Lapse Behavior in Long-Term Insurance: A Case Study*, 78 J. RISK & INS. 983, 986–87 (2011) (describing the benefit to the insurer from policyholder lapses when insurance pricing is front-loaded, as is the case in long-term care and some forms of life insurance); cf. Andrew Harley & Ian Farr, *How Can Life Insurers Improve the Performance of Their In-Force Portfolio? A Systematic Approach Covering All Drivers Is Essential*, REINSURANCE NEWS, July 2016, at 19, 21–22, https://www.soa.org/globalassets/assets/library/news_letters/reinsurance-section-news/2016/july/rsn-2016-iss85.pdf [<https://perma.cc/LDL2-LWCH>] (recommending that insurers “establish mechanisms to focus their retention management activities on higher-value customers” as an example of “smart customer handling [relating to] treating customers differently depending on the underlying financial attractiveness of their policy to the insurer”).

¹⁵¹ See, e.g., Oliver Ralph, *Europe’s Life Insurers Fall into the Hands of Private Equity*, FIN. TIMES (Oct. 22, 2018), <https://www.ft.com/content/4e89ff8e-c8af-11e8-ba8f-ee390057b8c9> [<https://perma.cc/TG88-9Z2B>] (noting that many prominent private equity groups were investing in European life insurance and pension organizations); *About Us: Our Vision and Values*, RESOLUTION LIFE, <https://resolutionlife.com/our-purpose/> [<https://perma.cc/5DCN-DHV9>] (“We are passionate about life insurance and the long-term commitment we have made to our customers.”).

¹⁵² See, e.g., Charles Ehrlich, *Found Money or Unobtainium: Security Deposits and the Run-off Company*, AIRROC MATTERS, Winter 2006–2007, at 21, 21–22 (describing ways in which runoff companies can use expertise and targeted resources to recover security postings, which can be an

fy market-segment-specific opportunities to contain and manage the legacy liabilities. Here are two examples.

a. Addressing the Coverage Litigation Collective Action Problem and Reducing Legal Spending in Liability Insurance Runoff

For technical reasons that are not important to understand in this context, any single significant asbestos liability defendant or hazardous waste site defendant may have dozens or even hundreds of individual liability insurance policies that provide coverage for all or part of its potential liabilities, issued by multiple insurance companies, over multiple decades.¹⁵³ In this circumstance, a well-counseled commercial policyholder can take advantage of what amounts to a collective action problem among its many insurance companies. The consolidation of most of the asbestos and environmental runoff liabilities of some of the largest insurers into the hands of a very small number of runoff specialists has changed this negotiating dynamic. Additionally, because the insurers for whom the specialists are managing the runoff no longer each need their own lawyer for all purposes, the consolidation has reduced insurers' insurance coverage litigation costs. That consolidation may also have the potential to address a similar collective action problem that results when the underlying plaintiffs sue many defendants.

important source of capital); Connie D. O'Mara & Bina Dagar, *Marcus Doran: Marcus Opens Up About the Biz, Life, Likes and Dislikes, and AIRROC*, AIRROC MATTERS, Fall 2014, at 24, 24 ("In respect to the run-off market, I've learned that it is a relationship business. The issues are complex, and there is a great deal of history between trading partners. Therefore, it is imperative to establish relationships based on respect, trust, and integrity."); Pomerantz et al., *supra* note 117, at 7–8 (noting that one important aspect of runoff management is making accurate assumptions about reinsurance collectibles, that require detailed knowledge about the current state of the market and observing that "if the company is going into runoff, it could change the assuming reinsurers' view on the way they are paying out because they've no longer got an ongoing relationship with that client" and observing that different (re)insurers have different "appetite for . . . commutation"; knowing that appetite allows you to better assess a potential runoff); *AIRROC—Thoughts on the Future*, VIMEO, at 0:01:30–0:01:40 (Sept. 1, 2017), <https://vimeo.com/232113382> [<https://perma.cc/22TX-Z63L>] (statement of Marianne Petillo) ("People who are in the runoff [side] now could go back into the ongoing side, and I think it will help control costs because people in the runoff side are always focusing on keeping costs low."). An early special issue of *AIRROC Matters* devoted to commutations reveals some of the nuances and relationships of commutations. See generally AIRROC MATTERS: SPECIAL EDITION—COMMUTATIONS, Summer 2007 (providing a swath of articles regarding the runoff industry's use of commutations).

¹⁵³ See Jeffrey W. Stempel, *Assessing the Coverage Carnage: Asbestos Liability and Insurance After Three Decades of Dispute*, 12 CONN. INS. L.J. 349, 372–75 (2006) (noting that universal changes in policy language led to a broadening of liability to multiple policies).

b. Rationalizing Legacy Information Technology in Life Insurance Runoff

Insurance companies are intensive users of information technology. The earliest “computers” were humans, many of whom worked for insurance companies, and the insurance industry has long been an important customer of information technology manufacturers.¹⁵⁴ For the life insurance industry especially, the rapid change of information technology presents a challenge to the consistent, reliable maintenance of processes and customer relationships under contracts that can last decades.¹⁵⁵ Each new life insurance product and each new feature in an existing life insurance product requires adjustments in information processing routines. Major updates in the core information technology of the life insurance company can require adjustments in hundreds, if not thousands, of policy management routines.¹⁵⁶ In many cases it makes more sense, especially in the short run, to keep those routines running on older systems. Not surprisingly, life insurance companies are full of legacy information technologies running processes for legacy insurance products.¹⁵⁷ A key selling point of life insurance runoff specialists is relief from the cost and headache of maintaining legacy information technology systems for an unprofitable and declining book of legacy policies.¹⁵⁸ Life insurance runoff specialists have become experts in converting multiple legacy life insurance books running on multiple legacy information systems to a common, more state-of-the-art information system, which is a concrete example of how the consolidation of insurance runoff reduces the marginal cost of managing the policies in runoff.¹⁵⁹

¹⁵⁴ See JOANNE YATES, STRUCTURING THE INFORMATION AGE: LIFE INSURANCE AND TECHNOLOGY IN THE TWENTIETH CENTURY 2–9 (2005).

¹⁵⁵ Matthias Daub & Ferruccio Lagutaine, *The Value in Outsourcing Legacy Insurance Products*, MCKINSEY & CO. (Dec. 1, 2010), <https://www.mckinsey.com/business-functions/operations/our-insights/the-value-in-outsourcing-legacy-insurance-products> [<https://perma.cc/VWN9-UKLQ>] (pointing out the significant processing and IT costs associated with servicing legacy policies that utilize outdated technology).

¹⁵⁶ See *id.* (remarking that this complexity accounts for up to seventy-five percent of IT costs).

¹⁵⁷ *Id.*

¹⁵⁸ See, e.g., *In Force Solutions*, WILTON RE, <https://www.wiltonre.com/in-force/> [<https://perma.cc/AR66-DR5J>] (“Our Administrative Services solutions provide for operational efficiencies by reliably transferring in force life insurance and annuity business to updated technology in a secure operating environment.”).

¹⁵⁹ See, e.g., Maurus Rischatsch & Mahesh H. Puttaiah, Swiss Re Inst., *Life In-Force Management: Improving Customer Value and Long-Term Profitability*, SIGMA, No. 6/2017, at 1, 35 (2017) (recommending “[b]ringing all operations onto a single, modern IT platform”); see also Interview with anonymous runoff market participant in N.Y.C., N.Y. (Mar. 6, 2019) (observing that the Swiss Re life insurance runoff market model is that there are zero marginal administrative costs because the business is almost completely automated).

3. Runoff Finance and Asset Management

The finance and asset management functions of insurance runoff specialists differ from those of active insurers in ways that reflect the narrower focus of runoff operations and, like the policy management examples just described, support the claim that consolidation leads to more efficient runoff operations.

Runoff finance is simpler than active insurance company finance because runoff companies have more focused operations and, hence, fewer expenses to project (and hold capital against): no salesforce, little to no marketing, few underwriters, and little brick and mortar.¹⁶⁰ A property casualty runoff company is, essentially, an insurance mergers and acquisition fund with a claims management department.¹⁶¹ A life insurance runoff company needs to add a policyholder management function, but because of the intensive use of information technology that function is highly automated, as explained in the life insurance policy management example above.¹⁶² Apart from these two management functions, a runoff company has more in common with acquisition vehicles, such as private equity funds, than an active insurance company. Perhaps for that reason, private equity funds hold substantial stakes in runoff companies.¹⁶³

Companies that specialize in runoff also invest their assets differently than active insurance companies. Among those companies for which it is possible to obtain asset information, the runoff companies invest in higher risk securities that, on average, yield a higher return than the investments of a comparison set of generalist property casualty companies, and a much larger share of the assets are invested in illiquid alternative assets.¹⁶⁴ My understanding

¹⁶⁰ Interview with anonymous runoff market participant in Phx., Ariz. (Jan. 31, 2019) (on file with author).

¹⁶¹ *Id.* I once happened to be sitting on a train next to a senior lawyer who worked at a runoff company. It was obvious to me that this person was a lawyer, so we started chatting about law practice. When I asked what the lawyer did, the lawyer replied, "I'm an M&A lawyer," figuring that there was no way that I would have heard of insurance runoff and that this more general title best described the role of a lawyer working as a runoff specialist. *See* Interview with anonymous runoff market participant in between Phila., Pa. and N.Y.C., N.Y. (Feb. 6, 2019).

¹⁶² *See supra* notes 154–159 and accompanying text (discussing the use of IT in life insurance).

¹⁶³ *See, e.g.*, Press Release, Athene Holdings Ltd. & Apollo Glob. Mgmt., Athene and Apollo Announce Transaction to Strengthen Strategic Relationship and Eliminate Athene's Multi-Class Share Structure (Oct. 28, 2019), <https://www.businesswire.com/news/home/20191028005346/en/Athene-Apollo-Announce-Transaction-Strengthen-Strategic-Relationship> [<https://perma.cc/S657-SLT9>] (reporting a purchase by Apollo Global Management, Inc., a private equity firm, of an 18% incremental stake in Athene, a runoff company); *About Us*, CATALINA, <https://www.catalina.com/about/> [<https://perma.cc/JS98-6ARL>] (describing how Catalina's shareholders, a runoff company, include Apollo, a private equity firm); *About Us: Corporate Profile*, WILTON RE, <https://www.wiltonre.com/corporate-profile/> [<https://perma.cc/KG2J-XXVZ>] ("Wilton Re is owned by the Canada Pension Plan Investment Board (CPPIB), the investment arm of one of the largest pension funds in the world.").

¹⁶⁴ The author's independent research comparing assets held by runoff insurers to that of traditional insurers illustrates this point. The comparison shows that runoff insurers percentage of invest-

from interviews is that this is true to an even greater extent for privately held runoff companies.¹⁶⁵ My working hypothesis is that runoff specialists take greater risk on the asset side of the balance sheet than most insurance companies for four main reasons (recognizing that not all of these reasons apply equally well to all the runoff specialists). First, as reinsurance companies, they are less heavily regulated than insurance companies.¹⁶⁶ Second, because they are already so deeply into the business of compromising their liabilities, the downside of taking risk on the asset side of their balance sheets does not threaten their business model, for example, because running into trouble on the asset side of their balance sheet simply increases their “financial distress” leverage with counterparties.¹⁶⁷ Third, the people who provide capital to the runoff specialists regard those specialists as high risk/high reward investments, and they are comfortable with the specialists taking risk on both sides of the balance sheets. Finally, to the extent that private equity backs the runoff specialist, the private equity owners may get an allocation of the assets to manage in their own funds, which will be recorded as (high risk) illiquid alternative assets on the runoff specialist’s balance sheet.¹⁶⁸

C. Rhetoric and Organizational Structure: The Runoff Stories

*We aren't the glamour kids . . . We are the ghosts of mistakes past, of the failures that had many fathers when they were shiny new ideas but are now orphaned in dismal disappointment. No one ever says, "this book/program is a great success, let's put it in run-off." So, by definition, we deal in failure.*¹⁶⁹

*No one puts good business into runoff.*¹⁷⁰

ment into alternative assets—hedge funds, private equity funds, debts funds, real estate, and venture capital funds—exceeds that of traditional insurers by two to three times. This comparison was made by investigation into the public filings of runoff companies—Enstar, Catalina, and R&Q—and comparing them to that of traditional insurers—Chubb, Travelers, AIG, Liberty Mutual, and CNA. See Investment Banking Portfolio (Mar. 24, 2019) (on file with author).

¹⁶⁵ Cf. Divya Kirti & Natasha Sarin, *What Private Equity Does Differently: Evidence from Life Insurance* 15–17, 21–22 (Univ. of Pa., Inst. for L. & Econ., Research Paper No. 20-17, 2020) (analyzing investment portfolios of life insurers acquired by private equity funds).

¹⁶⁶ Aviva Abramovsky, *Reinsurance: The Silent Regulator*, 15 CONN. INS. L.J. 345, 350 (2009) (“[O]ther than as regards some issues of solvency, the reinsurance industry is generally unregulated at all.”).

¹⁶⁷ See *supra* notes 127–134 and accompanying text (discussing the prevalence of commutation in the runoff industry); *supra* notes 140–141 and accompanying text (noting how runoff companies can use distressed financial situations to their advantage when negotiating commutations).

¹⁶⁸ E-mail from anonymous runoff market participant, *supra* note 96.

¹⁶⁹ Ehrlich, *supra* note 95.

¹⁷⁰ Interview with anonymous runoff market participant in Fla. (Jan. 15, 2019) (on file with author).

As just described, runoff underwriting reprices legacy liabilities with the benefit of hindsight; runoff policy management consolidates those liabilities, develops relevant expertise, and identifies and executes operational efficiencies; runoff asset management takes calculated risks that encourage additional providers of capital to enter the runoff market; and runoff finance facilitates lower cost planning for the process of the runoff.¹⁷¹ Runoff specialists undoubtedly do not execute any of these activities with perfection, but they have a decent claim to better execution than is possible inside an active insurance company, for which the liabilities in runoff are a dwindling and unpleasant reminder of the underwriting mistakes of the past.¹⁷²

Insurance runoff also operates through a rhetorical and organizational process that begins long before the runoff market transaction takes place. This process reconceptualizes a large, diverse number of individual insurance relationships into segregable books of legacy insurance liabilities that can be managed distinctly from those of the insurer's active business.

This reconceptualization happens slowly. As the time when the insurer sold the policies recedes into the past, insurance company personnel increasingly understand and categorize the policies in terms of the claims presented and the liabilities carried on the company's financial statements, as opposed to the identities, activities, or other distinguishing features of individual policyholders that company underwriters considered during the sales process. Company actuaries track the financial results of the policies using statistics like the underwriting ratio, which compares the premiums collected for blocks of policies to the losses incurred under those blocks of policies.¹⁷³ Gradually, the actuaries develop and propagate the understanding that a particular block of policies—understood as an aggregate—was a losing proposition for the company, and, therefore, that this group of policyholders got more than they paid for.¹⁷⁴

¹⁷¹ See *supra* notes 117–168 and accompanying text (discussing mechanics of the runoff industry).

¹⁷² See *supra* notes 152–159 and accompanying text (exemplifying advantages that are afforded to runoff companies because of specialization and expertise in dealing with runoff situations). To be clear, not all runoff transactions can fairly be characterized as “the ghosts of mistakes past” referred to in the quote above. Although that characterization is fair for the APH transactions like Lloyd's reconstruction and renewal, runoff market participants emphasize that some, more recent transactions simply reflect trades between insurers that wish to release the capital that they would otherwise have to hold against long-term risks with runoff specialists that are looking to increase the assets that they manage. See, e.g., E-mail from anonymous runoff market participant, *supra* note 96.

¹⁷³ For an explanation of the underwriting ratio, see Letter from Warren Buffett, *supra* note 60, at 7–10 (explaining how underwriting losses are calculated and explaining why he prefers a measure that takes the investment income into account).

¹⁷⁴ See, e.g., John West, *Managing the Past in the Future*, AIRROC MATTERS, Fall 2013, at 12, 13 (describing a typical runoff situation as follows: “There is no premium flow to offset the cost of those staff members. The loss ratio on the original business has long since exceeded 200%. Of the \$20 million in outstanding reserves, investment income is currently generating about 3.5% per year. That

At some point in this process, company underwriters decide not to sell new policies into this market (or not to cover these kinds of risks on an ongoing basis), confirming what the people involved in managing the claims and reserves already knew: this book of policies is non-core, unwanted business that does not represent the future of the company.¹⁷⁵ Indeed, this book of policies might even threaten the financial health of the company, making work on the book perilous to the careers of the people in the company who are responsible in the ordinary course for managing claims and setting reserves.¹⁷⁶ Identifying the book as being “in runoff,” and shifting the management of that book to runoff specialists mitigates that career risk.¹⁷⁷ The rhetoric and organizational logic of runoff normalizes that process:

“Run-off” is an organic, positive necessary part of a healthy (re)insurance industry. Businesses need to test new markets and products; often, the outcome is “run-off.” Ultimately, most relationships end. What happens? Run-off. Customer requirements and demands change. Results? Run-off. Specialists and dedicated professionals are needed to deal with the most volatile—and therefore the most important—of the insurance industry’s protections against catastrophe.¹⁷⁸

This transition to runoff is an extension of the process that routinely occurs in the insurance business as policyholders transition from the sales side of the insurance relationship to the claims side of that relationship. As prior work

equates to \$700,000. Those 10 staff members and their associated costs could total \$1.14 million per year. Just on the face of it, there is a huge disparity between the income and the outgo on this aged business!”).

¹⁷⁵ For a stylized parable of how this can happen, see Fitzpatrick, *supra* note 18, at 270–73.

¹⁷⁶ Iacovides, *supra* note 114, at 20 (“The continued lack of investment returns, the need to ring-fence exposure, the more stringent regulatory obligations coupled with the additional capital required to simply operate and write the same level of business; each continues to drive the search for ways with which to limit an insurer’s exposure to the unknown or uncertain and to deliver value to the shareholders.”); Eleni Iacovides, *The Legacy Market*, AIRROC MATTERS, Spring 2017, at 15, 15 (“Solvency II, the relatively new European regulatory framework, along with the low investment returns, soft market and pressure on underwriting profit has forced insurers to focus, more than ever, on the cost of capital and consequently on capital efficiency, in addition to the need for optimization of internal resources and cost reduction. Reserves held for old, discontinued or non-core business have become more capital intensive, therefore restricting insurers’ ability to deploy capital elsewhere such as new products, digitalization or a strategy to increase one’s market share in core business or a new jurisdiction.”); Luann M. Petrellis, *Can U.S. Insurance Companies Afford Not to Restructure?*, AIRROC MATTERS, Winter 2016–2017, at 6, 6 (“The pressure is now on all insurance carriers to manage their capital more efficiently.”).

¹⁷⁷ See Fitzpatrick, *supra* note 18, at 272 (noting in its example that after seeing long-term profitability is not possible, Beta will leave the specific policy market).

¹⁷⁸ Andrew Maneval, *Why We Work in “Run-off,”* AIRROC MATTERS, Fall 2014, at 9, 10.

has shown, insurers tell different sets of stories about insurance when communicating with policyholders during the sales and claims processes:

In the first set of stories—the sales stories—insurance companies promise complete protection from the risks addressed by any given line of insurance. In the second set of stories—the claims stories—insurance companies explain why it is that “complete protection” sometimes amounts to a little less; why it is, in other words, that some risks are *not* shifted to the insurance company.¹⁷⁹

The sales stories highlight policyholders’ vulnerability and dependence, and they convey the message that insurers can be trusted to fulfill their promise to be there in time of need.¹⁸⁰ By contrast, the claims stories stress the limits of the insurance contract, the insurance company’s responsibility to future claimants, and the need to protect the insurance pool from policyholders who take unfair advantage.¹⁸¹

Insurers reduce the opportunity for these two sets of stories to come directly into conflict “by separating the organizational responsibility for the narration of the two sets of stories.”¹⁸² The companies’ marketing departments articulate the sales stories, meanwhile the claims departments convey the claims stories.¹⁸³ The sales stories help persuade people to buy insurance. The claims stories help people accept that there are limits on the protection that insurance provides.¹⁸⁴

The transition to runoff involves a third set of stories, told by people with yet another organizational responsibility: the runoff professionals. As with the prior work on sales and claims stories, I am in this retelling simply reporting the stories, not endorsing them.¹⁸⁵ These runoff stories refer to “legacy liabilities” that represent a “drag” on insurance performance and that “trap capital” that could otherwise be put to better use.¹⁸⁶ Unlike the individualized promises of the sales stories and the contractual obligations of the claims stories, legacy liabilities are actuarial representations of contingent future payments to an ab-

¹⁷⁹ See Baker, *supra* note 29, at 1400.

¹⁸⁰ *Id.* at 1403–07.

¹⁸¹ *Id.* at 1407–13.

¹⁸² *Id.* at 1415–16.

¹⁸³ *Id.* at 1416.

¹⁸⁴ *Id.* at 1414.

¹⁸⁵ See *id.* at 1400 (presenting, objectively, the claims and sales stories).

¹⁸⁶ See, e.g., *About Us: How We Operate*, RESOLUTION LIFE, <https://resolutionlife.com/about-us/how-we-operate/> [<https://perma.cc/MWN8-DQFR>] (“Many life insurance companies are reorganising their business and divesting non-core, less profitable or capital-intensive business units, and books of business We acquire and consolidate life insurance businesses and apply our expertise . . . to improve their performance and achieve operational efficiencies.”).

strict collectivity. Unlike these promises and obligations, legacy liabilities can be accelerated and compromised, and, perhaps, delayed and denied.¹⁸⁷ Compromising and accelerating those liabilities can be a fair thing to do, at least for large commercial policyholders and for reinsurance cedents (insurance companies that bought reinsurance), because, with the benefit of hindsight, it is clear that the policyholders/cedents who bought that (re)insurance got far more than they paid for.¹⁸⁸ Although each individual policyholder or cedent retains the contractual right to insist on the payment of its claims as they become due, the runoff administrators also have the right to revisit the prior process for paying claims on this legacy book of business to search for previously unrecognized or unasserted coverage defenses and for other ways to “manage expenses.” Thus, this process encourages policyholders/cedents to recognize that compromise should be the normal, accepted practice in the runoff context for them as well.¹⁸⁹

The runoff stories posit several benefits that the runoff market provides to the broader insurance market. Runoff transactions unlock value by transferring legacy books of insurance policies to companies that value those books more highly, providing access to capital that the originating insurers can use to expand their core, active insurance business, allowing them to do business and write policies that they want to, thereby increasing the availability of (re)insurance.¹⁹⁰ Because runoff specialists administer legacy (re)insurance policies more efficiently, the runoff market lowers the cost, and hence the price, of insurance.¹⁹¹ Finally, the runoff market allows insurance groups to unwind their

¹⁸⁷ See *supra* notes 126–152 and accompanying text (discussing the policy management features unique to or heavily utilized in the runoff industry).

¹⁸⁸ See Fitzpatrick, *supra* note 18, at 272 (exemplifying that after years of claim payouts it becomes certain the company will lose money on all years of the policies issued). Note that the runoff trade literature and the runoff market participants that I interviewed exclusively employ this reasoning in relation to cedents and large commercial policyholders, not retail insurance customers, though my suspicion is that long-term-care insurers may be different.

¹⁸⁹ *E.g.*, Interview with anonymous runoff market participant in Phila., Pa., *supra* note 145 (describing the following arguments made in a reinsurance runoff: “You’re big enough to understand credit risk; you’re not the guy in the street.” “A bird in the hand is worth two in the bush.” “We’re in runoff; we’re trying to downsize; we’re willing to give you assets today; who knows what we’ll be able to give you later.” “You’re a big company. You’re supposed to know how the world works.”); see *supra* notes 98–106 and accompanying text (discussing that the legal rule is to allow for insured parties to retain their right to repayment from the original insurer).

¹⁹⁰ See Iacovides, *supra* note 176, at 17 (noting that runoff transactions allow insurers to explore more profitable business); see also E-mail from anonymous runoff market participant to author (Jan. 31, 2019) (on file with author) (“As bottom feeders (not a pleasant analogy) we serve a valid and vital purpose. We do indeed release capital back to the market.”).

¹⁹¹ See Iacovides, *supra* note 176, at 17 (“[Runoff transactions] release capital, allow the [original insurer] to achieve higher ROE [return on equity] by investing released capital in more profitable and/or core business, reduce the insurer’s exposure to potentially long-tail and volatile business and reduce operational overheads. Employing these solutions also often receives support from the [origi-

struggling subsidiaries outside of the cumbersome and expensive insurance insolvency process, reducing the drain that insurance guaranty funds impose on the active insurance market.¹⁹²

There are several obvious countervailing concerns that can and should inform an evaluation of the merits of any runoff transaction and the runoff market's contribution to social welfare more generally. I describe those concerns, so as not to leave the misimpression that I am unaware of them or that I have uncritically accepted the view of the world that the runoff stories reflect, but the evaluation of the social welfare of runoff lies outside the scope of this Article. Such an evaluation would require different methods than those I have employed here.

The most obvious countervailing concerns include the following. First, runoff transactions could be used to move legacy obligations into, or leave those obligations in, entities without sufficient assets to support them.¹⁹³ Second, even if the runoff entities are sufficiently capitalized, the runoff specialists may not have the same incentive as the originating (re)insurers to fulfill the underlying contractual obligations.¹⁹⁴ Third, even if they do have, or can be made to have, the same incentives and capacity as the originating (re)insurers, those incentives do not necessarily favor policyholders and cedents, and the runoff specialists' expertise in commutations and other ways of managing expenses may mean that policyholders and cedents take larger haircuts from run-

nal insurer's] regulator as regulators are now more than ever, keen to support any steps taken by insurers which are likely to avoid failure.”)

¹⁹² See, e.g., *id.* An insurance guaranty fund is the insurance market equivalent of the Federal Deposit Insurance Corporation, with the crucial difference that, unlike the FDIC, insurance guaranty funds do not accumulate a reserve in advance. Rather, they assess their members after the fact, whenever a member becomes insolvent. See TOM BAKER & KYLE D. LOGUE, *INSURANCE LAW AND POLICY* 665–71 (4th ed. 2017).

¹⁹³ This is the insurance instantiation of the dynamic Lynn LoPucki described over twenty years ago. See Lynn M. LoPucki, *The Death of Liability*, 106 *YALE L.J.* 1, 54 (1996) (warning that asset securitization will allow a company to sever financial accountability for liabilities without addressing them). The way to use a runoff transaction to leave legacy obligations in an underfunded entity is to structure the transaction to transfer the “good” business and the assets that support it into a newly formed entity, while leaving the “bad” business in the originating entity. The administrative law challenge to the New York Department of Financial Service's approval of the restructuring of MBIA during the Financial Crisis alleged that was the intended purpose of the restructuring. See *ABN AMRO Bank, N.V. v. MBIA Inc.*, 952 N.E.2d 463, 466 (N.Y. 2011).

¹⁹⁴ See, e.g., John M. Sylvester & Max Louik, *Policyholder Litigation Challenging the Claims-Handling Conduct of Resolute Management*, 28 *ENV'T CLAIMS J.* 97, 98 (2016) (“Once Resolute takes control of claims handling for the ceding insurer, Resolute has been known to pursue very aggressive strategies to reduce and delay the payout of coverage dollars to policyholders, the payment of attorneys fees to defense counsel, and the offering and payment of settlement amounts to underlying claimants.”).

off specialists than they would from (re)insurers running off their own risks.¹⁹⁵ Fourth, even if most runoff specialists would like to pay claims responsibly, the existence of a few that are willing to flout customary insurance market norms places pressure on the others to do likewise.¹⁹⁶ Finally, dividing or unwinding troubled (re)insurers outside of the insolvency process shifts risks to policyholders from shareholders, who are supposed to be the first to come up short when assets are insufficient to cover liabilities.¹⁹⁷

Runoff boosters have answers to these concerns that I report here, once again without assessing their merits. Above all, the boosters point to contract law and insurance regulation. When a runoff transaction involves reinsurance, the originating insurers remain legally responsible for their policies, and, thus, the transaction should not affect the amount of assets available to honor the liabilities or the incentives of the originating insurer.¹⁹⁸ When the transaction involves the sale of an entire entity in runoff, the transaction cannot take place unless the insurance regulator in the state of domicile approves, and regulators are not supposed to approve runoff transactions that put or leave insurance liabilities in entities without sufficient assets.¹⁹⁹ Additionally, because runoff specialists need a constant supply of new transactions, they have an incentive to treat policyholders and cedents fairly on their old deals or they will not get new reinsurance deals, and regulators won't approve new acquisition deals.²⁰⁰ Further, the boosters assert that the focus and expertise of the runoff companies

¹⁹⁵ See *supra* notes 128–159 and accompanying text (discussing the advantages that specialization in runoff gives runoff companies, including but not limited to commutation practice). From my interviews I developed the distinct impression that this is a widely shared belief among insurance company personnel responsible for collecting reinsurance. Whether this is a selection effect or a causal explanation is not knowable absent the kind of well-designed empirical research that is highly unlikely ever to be done.

¹⁹⁶ One industry insider described the claims payment strategy of a certain runoff specialist as, “Don’t answer the phone or, even better, don’t have a phone.” Interview with anonymous runoff market participant in Hartford, *supra* note 138.

¹⁹⁷ See, e.g., Richard E. Stewart & Steven E. Sigalow, *How Lloyd’s Saved Itself*, 37 *INS. F.* 9, 15–16 (2010) (contrasting the situation of troubled banks, whose shareholders “have been severely penalized or wiped out entirely,” with the treatment of Lloyd’s Names, whom Equitas insulated from pre-1993 losses).

¹⁹⁸ See *supra* notes 98–116 and accompanying text (discussing the legal mechanics and structure of runoff transactions and noting that most do not terminate the original insurer’s obligation). Of course, if the transaction releases capital to the counterparty that is then paid out or used to fund ventures that don’t work, then there are fewer assets.

¹⁹⁹ See Eleni Iacovides, *The Legacy Market*, AIRROC MATTERS, Winter 2017–2018, at 11, 13 (discussing that policyholder protection is the critical inquiry for approving regulators).

²⁰⁰ *Id.* at 11 (observing that a runoff acquirer is “keen to preserve its own reputation in order to gain more business from the same client, new clients, to grow”). One market participant described his company as follows: “[Company] is like a shark in the water. We have to get water over our gills via continually acquiring new portfolios.” E-mail from anonymous runoff market participant to author (Jan. 30, 2019) (on file with author).

helps policyholders more than it hurts them, particularly in the later stages of the runoff, when the originating insurer would have lost or redeployed the most competent claims handlers.²⁰¹ Finally, insolvency is a long, drawn-out, inefficient, and expensive process (think *Bleak House*) that returns less to most policyholders than a private runoff, and policyholders who would receive more in receivership can always hold out for that result.²⁰²

CONCLUSION: LESSONS FOR LEGAL THOUGHT

The rise of the runoff market has expanded insurers' options for managing their legacy liabilities.²⁰³ Whether that development benefits policyholders and (re)insurance companies equally is an important question, but one that requires different research methods to answer with certainty than the qualitative methods I report in this Article. My conclusion is that the benefits to the insurance market are real, especially when it comes to the runoff of reinsurance obligations, but there also are real countervailing concerns, especially for consumer and small to medium enterprise policyholders.²⁰⁴

The kind of empirical research needed to provide conclusive evidence regarding the social welfare benefits of the runoff market has not been done and most likely never will be done, among other reasons because of the limits of publicly available data.²⁰⁵ In my view, the benefits outweigh the costs for reinsurance treaty runoff. Additionally, the benefits may well outweigh the costs for large commercial policy runoff, if there remains a meaningful bad faith remedy to encourage responsible claim payment practices. Finally, there is even a case to be made that the benefits outweigh the costs for consumer and small business market runoff, if regulators remain vigilant and, even more importantly, there are private enforcement tools sufficient to motivate high quality lawyers to bring actions that discourage bad apples. That is, however, just

²⁰¹ See Slide Deck from AIRROC Webinar Series: Introduction to Run-off 7 (Feb. 6, 2019) ("In the early 1970's . . . [Run-off] was just an embarrassing reality of underwriting gone astray. Companies not only didn't highlight it, but in many cases tried to ignore it. Since the only real surviving function was claims handling, that would fall to either the newest or oldest claims associates within the company. It was perceived as a dead end opportunity.").

²⁰² Interview with anonymous runoff market participant in Bryn Mawr, Pa. (May 7, 2019) (on file with author). See generally CHARLES DICKENS, *BLEAK HOUSE* (1853) (critiquing the legal profession through the tale of a long-lasting legal dispute surrounding a testator's conflicting wills).

²⁰³ See *supra* notes 81–202 and accompanying text (discussing the mechanics and structure of insurance runoff).

²⁰⁴ See *supra* notes 57–80 and accompanying text (describing some of the early runoff transactions and the benefits provided to the insurance industry dealing with rising environmental liabilities); *supra* notes 190–202 and accompanying text (discussing the benefits and countervailing concerns of the runoff market).

²⁰⁵ See *supra* notes 92–93 and accompanying text (noting the difficulty of accessing large amounts of data because of the tight knit nature of the runoff industry).

my view. The outcome of a careful weighing of the pros and cons of the insurance runoff market remains uncertain.

All that is certain, and all that this Article aspires to use the runoff market to demonstrate to legal theory, are the following three points. First, insurers are more actively involved in managing uncertainty than the ideal type of the fixed-in-advance distribution of determinable risks would suggest.²⁰⁶ Second, insurance markets have the capacity to innovate in response to shocks: shocks from legal change, such as the asbestos and environmental liability experience that started the rise of runoff; shocks on the asset side of the balance sheet, such as the prolonged, extreme decline in interest rates that led to the rise of runoff in the life and pension business; and shocks from major changes in end of life care that, along with the decline in interest rates, may lead to a rise in the long-term-care runoff market, recognizing that careful analysis of long-term-care runoff awaits future work.²⁰⁷ Third, as a result of insurers' experience managing uncertainty and insurance markets' capacity to innovate, those markets are far more resilient in the face of legal change and other sources of uncertainty than the prevailing ideal type would suggest.²⁰⁸

Indeed, the rise of insurance runoff suggests that we may have learned exactly the wrong lesson from the insurance industry's harrowing asbestos and environmental liability experience.²⁰⁹ That experience involved retroactive, strict liability for activities undertaken on a widespread basis for decades. For asbestos miners and manufacturers, the unanticipated liabilities came from

²⁰⁶ Compare, e.g., DWORKIN, *supra* note 1, at 78–79 (discussing the “value of insurance” in ways that imply a fixed-in-advance distribution of determinable risks), and ABRAHAM, *supra* note 5, at 946–47 (“Insurance operates most comfortably with stochastic events, in which the probability of the frequency and magnitude of insured losses that will be suffered by a group of policyholders is highly predictable.”), and Priest, *supra* note 1, at 1539–40 (“Insurance . . . requires that the loss be probabilistic, either as to whether or not it occurs at all (for example, whether one’s house burns down) or as to when the loss occurs (for example, whether one dies before or after full life expectancy.”), and Wade, *supra* note 5, at 755 (“How does one spread the potential loss of an unknowable hazard? How can insurance premiums be figured for this purpose? Indeed, will insurance be available at all?”), with *supra* notes 51–80 and accompanying text (highlighting the Lloyd’s Reconstruction and Renewal and how it jump-started the development of the modern day runoff market), and *supra* notes 98–116 and accompanying text (describing the mechanics and structures that are hallmarks of the runoff industry).

²⁰⁷ See *supra* notes 56–80 and accompanying text (discussing the rise of asbestos and other environmental liability and how it led to the Lloyd’s Reconstruction and Renewal that helped start the rise of the runoff industry); *supra* notes 146–151 and accompanying text (noting that asset side shocks caused by interest rate adjustment and long-term healthcare generated the runoff market for life insurance).

²⁰⁸ See *supra* notes 117–168 (exemplifying that the specific underwriting, claim management, finance, and asset management practices of runoff companies transforms policies that were once thought of as mere future uncertainties into market tradable risks).

²⁰⁹ Cf. Stempel, *supra* note 153, at 464–66 (discussing the outcomes and lessons learned for insurers from the asbestos liability experience, particularly to be more alert and react swiftly to constrict coverage of budding mass torts).

common law innovations in the 1960s and 1970s.²¹⁰ For hazardous waste producers and transporters and for the owners of hazardous waste sites, the unanticipated liabilities came from statutory liabilities adopted in the early 1980s.²¹¹ These liabilities landed on liability insurers through the promises they made in insurance policies they sold to asbestos miners and manufacturers, hazardous wastes producers and transporters, and property owners dating back to the 1940s—promises that could not be repriced and for which the insurance industry had not anticipated anything like the extensive losses that resulted.²¹² Those unanticipated insurance liabilities lead to massive losses for the leading liability insurance companies and, eventually, one of the most significant innovations in the liability insurance market in the 20th century: the rise of insurance runoff.²¹³

The right lesson to draw from this experience is not that insurance markets need legal certainty, but rather that insurance markets are resilient and innovative enough to handle even extreme legal uncertainties.²¹⁴ If the liability insurance market can absorb widespread, retroactive, and truly strict liability for asbestos injuries and the costs of cleaning up hazardous waste, then legal scholars, judges, and legislators can safely focus more on identifying the just distribution of legal rights and obligations and less on the destabilizing impact that moving toward that distribution might have on insurance markets. Perhaps ironically, this more realistic understanding of insurance markets may hold the greatest promise within legal thought for scholars whose ideas least take markets into account, because they already have discounted any concerns that adopting their ideas would destabilize insurance markets.²¹⁵

²¹⁰ See, e.g., *Borel v. Fibreboard Paper Prods. Corp.*, 493 F.2d 1076, 1103 (5th Cir. 1973) (recognizing a duty to warn of foreseeable dangers of products for manufacturers of those products and applying this duty to an asbestos manufacturer).

²¹¹ See *Developments in the Law: Toxic Waste Litigation*, 99 HARV. L. REV. 1458, 1470–77, 1511–17 (1986).

²¹² See, e.g., Stempel, *supra* note 153, at 416–17 (describing some insolvencies and drag on earnings of insurers because of asbestos coverage).

²¹³ See *id.* (discussing insolvencies, drags on earnings, and the most famous insurance runoff transaction, Lloyd’s Reconstruction and Renewal).

²¹⁴ Cf. Abraham, *supra* note 5, at 946–47 (“Insurance operates most comfortably with stochastic events, in which the probability of the frequency and magnitude of insured losses that will be suffered by a group of policyholders is highly predictable.”); Baker, *supra* note 22, at 130–42 (providing a context for understanding how uncertainty has impacted insurance markets through liability development risks); Geistfeld, *supra* note 22, at 549 (discussing how legal ambiguity within tort law increases uncertainty and intersects insurance and tort reform).

²¹⁵ See, e.g., John C.P. Goldberg & Benjamin C. Zipursky, *Tort Law and Responsibility*, in PHILLOSOPHICAL FOUNDATIONS OF THE LAW OF TORTS 17, 17–18, 26–38 (John Oberdick ed., 2014) (arguing for the restoration of responsibility to tort law); ARTHUR RIPSTEIN, *PRIVATE WRONGS* 8–29 (2016) (deriving tort law rules from foundational moral principles); cf. Allison K. Hoffman, *Health Care’s Market Bureaucracy*, 66 UCLA L. REV. 1926, 1926, 1951–67, 1972–89, 1992–2002 (2019)

Although no single qualitative study can prove that the prevailing insurance ideal type—the fixed-in-advance distribution of determinable risks—fails to capture the real-life operation of the insurance business, even one such study can demonstrate that insurance operates outside this ideal type. The accumulating weight of studies, to which the research on runoff reported in this Article contributes, suggests that the insurance industry so regularly operates in the realm of uncertainty that this ideal type should be abandoned as the model of how insurance generally works, even if it might continue to have some validity in some sectors of the insurance market and significant value in theoretical work.²¹⁶

In that regard, as I emphasized at the outset, it is important not to exoticize the insurance runoff transactions explored in this Article. The rise of runoff did not create insurers' need or capacity to manage uncertainty. It simply helps bring that need into clearer view and provides another demonstration of that capacity to manage it. Every insurance policy goes into a kind of runoff the moment it is sold. The promises made in all insurance policies get bundled and reconceptualized into sets of liabilities that are valued and revalued, further combined and recombined over time. Some sets of liabilities perform better than expected; others perform worse. Insurers use profits earned on the better performing sets to offset losses on the worse performing sets, and if too many sets perform too badly, insurers must raise prices on their new policies. Insurers back the promises and contractual obligations featured in their sales and claims stories with large, general accounts precisely so that they can make these kinds of adjustments across sets of liabilities and assets over time. Cross subsidies abound.²¹⁷

These post-underwriting adjustments take place not just for the long term, legacy insurance obligations traded in the runoff insurance market. Even short-term insurance obligations like private passenger auto and homeowners policies face significant uncertainties from factors such as changes in underwriting and risk classification technologies, new entries into the insurance market (think insuretech today), changes in legal rules regarding residual markets, changes in the mix or risk appetite of reinsurers in a market, changes in auto

(documenting ways in which market-based approaches to health care “fail to capture what people want.”).

²¹⁶ See Stapleton, *supra* note 10, at 842 (noting that the typical insurance model does not extend to auto torts because the pool of policyholders and their risk of injuring are not measurable). *But see supra* notes 1–6 and accompanying text (recognizing that many fields use this prevailing idea of insurance and conceding that at least in some areas there is normative value to its use); *infra* notes 222–224 and accompanying text (discussing the benefits of using this simplified view of insurance). *See generally* ERICSON & DOYLE, *supra* note 17 (noting uncertainty in multiple areas of insurance).

²¹⁷ *See supra* notes 173–189 and accompanying text (discussing this process of actuarial reconceptualization and how this affects insurers' business models).

and home construction technology, and, of course, changes in the legal rules regarding liability or insurance.²¹⁸ The runoff market targets longer term obligations, not because they are uniquely uncertain, but rather because their longer duration provides greater opportunities for specialists to earn a return through financial engineering or liability management.²¹⁹

Industry leaders understand that a precise match between the price charged for one set of insurance policies and the losses incurred in that set is rare. A precise match is the goal, however, and, thus, achieving it is not an accident. Nevertheless, there are too many moving parts to almost any insurance business and too much uncertainty for that goal to be achieved very often.²²⁰ There is no such thing in real-world insurance markets as the fixed-in-advance distribution of fully determinable risks. There is always some uncertainty, and the accumulating weight of research suggests that the extent of that uncertainty is quite substantial.²²¹

Nevertheless, that ideal type can be useful for insurers: as an aspiration for underwriters and actuaries, as an explanation for why claims managers should not make exceptions in needy cases, and as a justification for resisting or promoting legal change. Because of this utility, industry leaders use the ideal type to describe how insurance markets work, in some cases almost certainly (and unfortunately) to an extent that diverges from their private understanding.

That ideal type also can be useful in legal thought, for example, to explore such important topics as the potential impact of liability insurance on deterrence,²²² the comparative advantages of public and private systems of compensation,²²³ and the consequences for health insurance markets of outlaw-

²¹⁸ See generally Baker, *supra* note 22 (surveying different risk factors that contribute to the overall uncertainty of insurance).

²¹⁹ See *id.* at 142–43 (noting that the length of liability does not create uncertainty, but rather, it magnifies it); *supra* notes 117–168 (discussing how specialization in runoff allows runoff companies to utilize methods of underwriting, claim management and asset management that allow for a return on their investment and thus incentivize them to acquire these legacy obligations).

²²⁰ See ERICSON ET AL., *supra* note 14, at 158 (paraphrasing and quoting an actuary as follows: “while actuarial science has all the trappings of science . . . it is best seen as providing a framework for a ‘guessing game’ . . . ‘You know you’re going to be wrong from the start.’”); Fitzpatrick, *supra* note 18, at 260 (“[T]he bottom line is that pricing uncertainty . . . [is] built into the very nature of insurance.”); *supra* notes 21–22 and accompanying text (discussing that although insurance professionals strive for this precise match it is ultimately a hopeless hypothetical endeavor).

²²¹ See *supra* notes 10–18 (describing scholarship and findings that push against this traditional and simplified view of insurance).

²²² See Shavell, *supra* note 16 (noting that liability insurers can view prevention measures and make insurance terms depend on that level of activity).

²²³ See Dwight Jaffee, *Catastrophe Insurance*, in RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW 160, 161–64 (Daniel Schwarcz & Peter Siegelman eds., 2015) (remarking that in catastrophe insurance private insurers are generally not well-capitalized enough to fully transfer the risk, which explains why the government has stepped in as a backstop).

ing preexisting condition exclusions and health-based pricing.²²⁴ For those and other similar purposes, the ideal type can serve as a useful, simple model of how insurance works, as long as the limits of the model remain firmly in mind.

Models, and theory more broadly, can help identify and perhaps even explain some of the problems and possibilities that exist in the world. But models also can misdiagnose problems and hide possibilities. When we act as if insurance markets require determinable risks whose distribution can be fixed in advance, we fail to see the many ways that insurance organizations manage uncertainty.²²⁵ We lose sight of the resilience in insurance markets and of the flexibility and innovation that produce that resilience. Keeping that resilience more firmly in mind, we should give less weight to theoretical arguments that this or that liability reform will undermine insurance markets. Insurance already involves so much uncertainty, and insurers have so many ways to manage it, that the most likely result will always be that they will continue to muddle through.

²²⁴ See Hoffman, *supra* note 12 (using the fixed-in-advance insurance type to explain how health insurance distributes risk and subsequently how outlawing preexisting exclusions would affect the market).

²²⁵ See, e.g., *supra* notes 81–202 and accompanying text (discussing the mechanics and structure of insurance runoff that help change the uncertainty of legacy liabilities into tradable risks).

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